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The Law Commission

Consultation Paper No. 124

Fiduciary Duties and Regulatory Rules

A Consultation Paper

HMSO

The Law Commission was set up by section 1 of the Law Commission Act 1965 for the purpose of promoting the reform of the law.

The Law Commissioners are:

The Honourable Mr. Justice Peter Gibson, *Chairman*
Mr. Trevor M. Aldridge
Mr. Jack Beatson
Mr. Richard Buxton, Q.C.
Professor Brenda Hoggett, Q.C.

The Secretary of the Law Commission is Mr. Michael Collon and its offices are at Conquest House, 37-38 John Street, Theobalds Road, London WC1N 2BQ.

This summary, completed on 3 April 1992, is circulated for comment and criticism only. It does not represent the final views of the Law Commission.

The Law Commission would be grateful for comments before 30 September 1992. All correspondence should be addressed to:

Mrs. R. Innes
Law Commission
Conquest House
37-38 John Street
Theobalds Road
London WC1N 2BQ

(Tel: 071-411 1284
Fax: 071-411 1297).

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The Law Commission

Consultation Paper No. 124

Fiduciary Duties and Regulatory Rules

A Consultation Paper

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THE LAW COMMISSION

CONSULTATION PAPER NO. 124

FIDUCIARY DUTIES AND REGULATORY RULES

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GLOSSARY OF ABBREVIATIONS

"**CACA**" means the Chartered Association of Certified Accountants.

"**Core Rules**" means The Core Conduct of Business Rules made by the SIB under FSA, section 48.

"**DTI**" means the Department of Trade and Industry.

"**FIMBRA**" means The Financial Intermediaries, Managers and Brokers Regulatory Association.

"**FSA**" means Financial Services Act 1986.

"**IB(R) Act**" means Insurance Brokers' (Registration) Act 1977.

"**IBRC**" means Insurance Brokers' Registration Council.

"**ICA**" means Insurance Companies Act 1982.

"**ICAEW**" means the Institute of Chartered Accountants for England and Wales.

"**IMRO**" means Investment Management Regulatory Organisation Limited.

"**LAUTRO**" means Lautro Limited, the Life Assurance and Unit Trust Regulatory Organisation.

"**RCH**" means Recognised Clearing House, i.e. a clearing house recognised by the Secretary of State under FSA, section 39.

"**RIE**" means Recognised Investment Exchange, i.e. an investment exchange recognised by the Secretary of State under FSA, section 37.

"**RPB**" means Recognised Professional Body, i.e. a body which regulates the practice of a profession and is recognised by the Secretary of State under FSA, section 18.

"**RSB**" means Recognised Supervisory Body, i.e. a body which maintains and enforces rules as to the eligibility of persons to seek appointment as company auditors and the conduct of company audit work which is recognised by the Secretary of State under Companies Act 1989, section 30 and Schedule 11.

"**SEC**" means the Securities and Exchange Commission.

"**SFA**" means the Securities and Futures Authority Limited.

"**SIB**" means the Securities and Investments Board.

"**SRO**" means a Self-Regulating Organisation recognised by the Secretary of State under FSA, section 10.

"**UCTA**" means Unfair Contract Terms Act 1977.

PART I

INTRODUCTION

The Scope of the Project

1.1 Situations in which professionals and businesses appear to owe conflicting duties to different customers or in which there is a conflict between their own interests and those of their customers are not new. Our legal system deals with many of them by treating as fiduciary the relationship between the provider and the recipient of services and conferring upon the recipient rights of action for breach of the "no conflict", "no profit" and "undivided loyalty" obligations.[1] However, the changes brought about by market developments, the requirements of competition law, and reforms in the structure of the financial markets in the mid-1980s, in particular the abolition in October 1986 of the Stock Exchange's single capacity requirement that segregated broker (agency) and dealer (principal) functions,[2] led to renewed concern about these conflicts and the adequacy of investor protection. As a result of these developments, and with a view to achieving economies of scale and to preserve the attractions of London as a financial centre, many financial institutions organised themselves as conglomerates offering a range of services. This enhanced the possibility that conflicts or potential conflicts of interest or of duty would occur.

1.2 At the time of the enactment of the FSA there was considerable discussion of these concerns and of the relationship between the new regulatory system and the common law and equitable rights of the customers of firms[3] subject to it. The issues concerned the impact of new market practices on the content of the fiduciary obligations and whether the regulatory system imposed duties on firms or permitted practices that were inconsistent with their fiduciary obligations. Were the new regulatory system and the rules made by the self regulating bodies to modify common law and equitable rights or were they to provide an additional set of safeguards for investors?[4] If the former, by what method would it be ensured that the level of investor protection was not diluted to an unacceptable degree? If the latter, would practitioners be subjected to conflicting obligations and how would the necessary degree of certainty be ensured? These issues, not addressed directly in the statute, were of concern to the financial markets and came to the surface again during the consideration of the amendments to the FSA in 1989.[5] In principle they can also arise in other regulated contexts.

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[1] See para. 2.4.9, below for an outline of these.

[2] See paras. 2.2.5-2.2.6, below.

[3] In this paper the term "firm" is used compendiously to cover every form of business (including professional) entity, whether corporate or unincorporated, save where it expressly appears otherwise.

1.3 Following a number of approaches and discussion between the Law Commission, the Department of Trade and Industry, the SIB, and other interested bodies, in particular the Company Law Committee of the Law Society, in April 1990 the Minister for Corporate Affairs made a reference to us in the following terms:

> "Certain professional and business activities are subject to public law regulation[6] by statutory and self-regulatory control. The Law Commission is to consider the effect of such controls on the fiduciary and analogous duties of those carrying on such activities, and to make recommendations. The inquiry will consider examples from differing areas of activity but will be with particular reference to financial services."[7]

A parallel reference was made to the Scottish Law Commission.

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[4] See para. 5.3.3, below.

[5] Companies Act 1989, Part VIII.

[6] For the meaning of this see paras. 5.2.1-5.2.7, below.

[7] Letter of 3 April 1990.

Defining the Problem

1.4 We believe the aims of the law must be: the adequate protection of those to whom fiduciary obligations are owed, the customers and in particular private customers, and the facilitation of the efficient functioning of the market in which there is reasonable certainty as to customers' rights and practitioners' duties. Customers may benefit from clear, properly enforced regulation as much if not more than from vague, privately-enforced fiduciary obligations. Careful practitioners who do all they can to follow the rules, "best market practices" and clear and well defined compliance procedures also benefit from certainty.

1.5 In November 1990 we circulated a Questionnaire seeking information about market practices so that we could assess the extent to which the relationship between fiduciary duties and regulatory rules is perceived to give rise to problems in practice, and the location and nature of any such problems. Our terms of reference include the many contexts in which professionals and businesses are subject to public law regulation. Given the width of this reference and the impossibility of giving detailed consideration to any one context without a full analysis of the often complex regulatory system governing it, we wished to target this consultation paper on those areas which have given particular cause for concern, while not losing sight of the other areas within the scope of the reference. The Scottish Law Commission circulated our Questionnaire to Scottish organisations with a covering note.

1.6 The Questionnaire was sent to firms, individuals, regulatory bodies and organisations representing the different interests involved (i.e. consumer, professional and business interests). We received 98 responses, mostly from professional and business interests (including trade associations) and regulatory bodies. The Scottish Law Commission received 6 replies from Scottish respondents. The responses are described in summary form in Appendix 1. The professions and businesses covered included accountancy, actuarial services, banking, conveyancing, corporate finance, estate agency, financial advice, insurance, investment management, legal services, stockbroking, surveying and valuation. The responses showed that the most difficult issues were perceived to arise in the context of financial services, although problems were not wholly confined to that context.

1.7 The responses to the Questionnaire have conditioned the approach taken in this paper in two ways. First, although we shall briefly set out the regulatory structure in a number of other areas, this paper concentrates on financial services and on rules made by the SIB and SROs under the FSA, but with particular reference to the Core Rules. In view of this it is important to emphasise that the problems are not the products of self-regulation but can arise under any system of regulation including governmental regulation. As litigation involving issues that concern us - the effect of Chinese walls and the impact of regulatory rules on private rights - has occurred in the context of solicitors, we shall consider that profession in some detail. On the whole, however, the regulatory rules governing lawyers tend to reinforce the fiduciary duties owed by them. Apart from concern about the operation of Chinese walls in solicitors' practices and the impact of regulations on the obligation of authorised conveyancing practitioners to account for commission received from mortgagees and insurers, respondents to the Questionnaire did not indicate that there were problems of mismatch between fiduciary obligation and regulatory rule in the provision of legal services. Secondly, the responses indicated that the problems that had arisen primarily concern fiduciary duties. Our analysis is accordingly focused on fiduciary duties. We believe that our general approach is, in principle, applicable to other forms of liability under the general law, such as liability for negligence. In principle most of the reasoning, in particular that in Part V concerning the public law dimension where we have drawn on the law of negligence,[8] would apply to liability in negligence.

1.8 At the outset we should make it clear that this paper will not consider the issues concerning the management of pension funds brought into prominence by the Maxwell pensions affair[9] and the current allegations of malpractice at Lloyd's.[10] While these have focused attention on weaknesses in both the general law and the relevant regulatory systems they do not raise problems of mismatch between regulatory rules and duties arising under the general law since what is alleged is not validated by the rules.

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[8] Para. 5.4.27, n. 212, below.

[9] See Second Report of the Social Security Committee, *The Operation of Pension Funds*, H.C. (1991-92) 61-II.

1.9 The responses to the Questionnaire showed that many of the problems that undoubtedly exist in modern professional and business organisations, particularly larger firms and integrated conglomerates, do not arise from a mismatch or a potential mismatch between the regulatory rules and the fiduciary obligations owed by firms. There are several other causes of these problems. Some arise from conflicts of interest which are not legitimated by the rules but which practitioners find it difficult to avoid. One well known example is the practice of Lloyd's brokers in acting for both the insured and the insurer when handling claims.[11] Another concerns the practice of estate agents marketing mortgage and insurance services for which the agent receives a commission. The regulations on estate agents made following an inquiry by the Office of Fair Trading increase requirements of disclosure about remuneration and prohibit discrimination against purchasers who are not accepting services from the agent or certain of his associates. These regulations reinforce rather than conflict with fiduciary duties and thus there is no significant practical scope for conflict or mismatch.[12] A third example might occur if a stockbroker who is instructed by a customer to build up a stake in a particular company with a view to a bid not only acts on behalf of the customer but also buys shares on its own account, possibly driving up the price the customer has to pay for subsequent purchases.[13]

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10. I.e. those relating to churning the same risk between syndicates to generate extra commission and the practice of keeping highly profitable "adolescent" syndicates for insiders.

11. See paras. 3.2.16-3.2.17, below.

12. The Estate Agents (Provision of Information) Regulations 1991 S.I. 1991/859; The Estate Agents (Undesirable Practices) Order 1991 S.I. 1991/861.

13. Report by D.T.I. Inspectors, *Consolidated Goldfields plc.* (1989), paras. 7.2-7.9. For further examples see Report by D.T.I. Inspectors, *The Milford Docks Company* (1992), Sections 4.5, 4.7, 5.6, 6.6, 8.6, 9.5.

1.10 The Investment Referee has informed us[14] that of 176 cases resolved by his office between May 1989 and September 1991, 123 did not appear to involve any element of a rule breach but turned on legal wrongs such as negligence, misrepresentation or breach of contract. Although 50 cases involved rule breaches, either failure to give best advice or failure to provide best execution or both, his view was that the rule breach normally also involved a legal wrong. His conclusion was that in the cases considered by his office it is rare to see evidence of conflicts between the general law and regulatory rules.

1.11 Other problems, notably the restrictions on the ability of trustees to delegate investment management discretion and the fact that a director of a company may also be a trustee of its pension fund, arise because of a perceived defect in the general law or as a direct result of statute as opposed to regulations.[15] None of these problems falls within the scope of our terms of reference although we note, with respect to delegation by trustees, that proposals for reform which would reduce the problem were made in 1982 by the Law Reform Committee[16] but have not been implemented.

1.12 Turning to matters within our terms of reference, first it is important to say that we are only concerned with whether a firm which follows what might be termed "best market practices" may nevertheless find itself in a situation in which the requirements of fiduciary law and those of the regulatory system either conflict or operate in an unharmonious and difficult manner. While those who do not follow best market practices may no doubt face difficulties, it is no part of our remit to consider whether the standards these practices reflect should be relaxed. That is a question for the relevant regulators although we doubt whether such relaxation could properly occur save where a compelling case can be made and the interests of lay and professional customers will be protected.

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[14] Letters of 30 September and 11 October 1991.

[15] For instance, auditors expressed concern about the modification of their duty of confidentiality by FSA, s. 109.

[16] 23rd Report of the Law Reform Committee, *Powers and Duties of Trustees*, Cmnd. 8733; see further Hayton,"Developing The Law Of Trusts For The Twenty-First Century", (1990) 106 L.Q.R 87, at 88-9.

1.13 Secondly, the main areas of potential conflict between duties under fiduciary law and what is required or permitted by regulatory rules concern disclosure of commission (including "soft" commission) and other remuneration, relaxation of the "no profit" rule, and the operation of Chinese walls.[17] There is a contrast between "real" conflicts of regulatory and general law (in the sense that compliance with one would necessarily constitute breach of the other) and situations in which the regulatory rule sets a less onerous standard than the general law but does not prohibit compliance with the higher standard. Rules made under FSA section 48(2)(h) authorising or requiring the withholding of information by one part of a firm's business from another part[18] may raise the possibility of a "real" conflict. Requirements about the timing and specificity of disclosure may not raise a "real" conflict in this sense but do raise the question of whether the rules offer a "safe harbour" for those who comply with them.[19] There is also a greyer area in which, while the rules do not directly sanction that which might arguably constitute a breach of fiduciary obligation, they might be thought to assume its legitimacy. An example of this concerns the use of blanket consents in advance in customer agreements, for instance, about the capacity in which a broker-dealer may be acting.[20] Although the number of these problems might not be large, where they do arise they go to the core of the structure of the financial markets.

1.14 Thirdly, our respondents' perceptions of whether problems in fact exist depended on their view of the efficacy of contractual provisions entered into at the commencement of a relationship with a customer and of arrangements for segregating information, for instance, by the use of Chinese walls. To this extent the issues we address are interrelated and cannot

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17. See para. 2.4.12, below for a fuller list of potential conflicts.

18. Set out at para. 4.5.12, below.

19. See paras. 5.3.12-5.3.20, below.

20. See paras. 3.4.2, 3.4.12-3.4.13, 3.4.34 and 5.3.29, below.

be considered in an entirely separate way. A significant number of our respondents considered that, although some of the practices set out in the Questionnaire were situations of potential conflict between fiduciary obligation and regulatory duty, there is no need for legislative intervention.

1.15 A majority of respondents considered that contractual arrangements giving the firm general consent in advance to do what would otherwise be a breach of fiduciary duty would normally be effective to modify the duty and prevent a breach from arising. A small majority considered that structural arrangements such as Chinese walls would, in practice, help to obviate potential liability. Many of these qualified their opinion in some way, for example, by stating that Chinese walls would "usually" suffice. The greatest difficulties were seen in relation to the rules on imputation of information, and those who did not consider that Chinese walls were effective thought that although they might help to avoid liability for breach of an obligation of confidence, the rules on the attribution of knowledge within a firm[21] and the existence of duties of disclosure[22] meant they could not guarantee legal immunity in all situations. As will be seen in Parts III and IV, although contractual and structural arrangements may often prevent a breach of duty arising, our provisional view is they do not do so in all cases and cannot, therefore, safely be relied upon. At its lowest there is great uncertainty about the position. We note that the submissions to the Legal Risk Review Committee, set up in April 1991, support the view that there are regulatory rules which are not completely congruent with common law and equitable obligations and cause real difficulties.[23]

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[21] See paras. 2.3.1-2.3.11, below.

[22] See paras. 2.4.9, 2.4.12(iv)(v) and 2.4.14(ii), below.

[23] *Reducing Uncertainty - The Way Forward* (1992), Appendix 2.

The Arrangement of This Paper

1.16 Parts II-V contain the factual and legal background to our inquiry and an account of the existing law while Part VI sets out the policy issues for consideration. Part VII gathers together our provisional conclusions and the consultation issues. In view of the length and complexity of this paper we have also published a summary which readers may find useful as an introduction to the full paper.

1.17 Part II contains outlines of the structure of the modern financial conglomerate, the rules on acquisition of knowledge by a firm, the relevant fiduciary duties and examples of situations in which conflicts arise, and an overview of the principal regulatory structures relevant to our inquiry.

1.18 Parts III and IV examine the extent to which potential breaches of duty may be avoided by contractual arrangements (including disclosure and customary trade practices), independence policies and Chinese walls. In view of the uncertainty as to the existing law and the fact that we do not share the view of many of our respondents that such contractual provisions and structural arrangements are effective in practice to prevent a breach of fiduciary duties from arising, a considerable part of this paper is concerned with elucidating and analysing the current position.

1.19 In the case of contractual arrangements, the issues are whether the fact that something is sanctioned by a regulatory rule affects the content of the fiduciary duty as a matter of private law and whether it is possible, practicable or satisfactory to resolve any problems by further adjustment to market practices, for instance, by further and more specific disclosures after the commencement of the relationship. In the case of Chinese walls, the question concerns the scope of the rules on attribution of knowledge within a firm, whether it is a single legal entity or a group. Those readers who require only an outline of the present law may find it sufficient to confine their attention to the following sections of Parts III and

IV: paragraphs 3.1.1-3.1.3, 3.2.24-3.2.25, 3.3.39-3.3.42, 3.4.37-3.4.39 (contract and disclosure), 4.4.1-4.4.2, 4.5.1-4.5.2 and 4.5.25 (independence policies and Chinese walls).

1.20 Part V considers whether the fact that the areas under consideration are subject to public law regulation affects or should affect the issues considered. The primary policy issue set out in Part VI is whether, in a situation in which there is a conflict between fiduciary obligations and regulatory rules, the law should always regard the classic formulation of fiduciary obligation as prevailing or whether, as in our provisional view, account should be taken of the regulatory rules in determining the content of the fiduciary obligation and whether it has been breached.

1.21 The other policy issues for consideration will depend on the answer given to the primary question. If the classic formulation of fiduciary obligation should always prevail save where modified in accordance with the rules of common law and equity, it is vital to determine whether the contractual and structural techniques considered in Parts III and IV are effective. If, as we believe, they are not effective, or at least there is considerable uncertainty about their efficacy, the questions are how, given the broad way fiduciary obligations are formulated, uncertainty can be minimised and how the law should handle conflicting and inconsistent duties. If, on the other hand, fiduciary law should take account of legislative interventions to the structure of the market and regulatory rules, the question is how precisely to do this. There are a number of possibilities, ranging from a "safe harbour" approach, whereby compliance with a regulatory rule would constitute a defence to any action for breach of fiduciary duty, to approaches which would permit the courts to take account of regulatory rules in determining the precise content of the relevant fiduciary obligations. The latter do not involve the courts' abdicating control in favour of regulators but accord some weight to the regulators' views in areas remitted to them by Parliament. The question is how much weight.

1.22 The Commission is most grateful to Professor D.D. Prentice of the University of Oxford who has acted as our consultant and has made a substantial contribution to the development of this project, and to Ms Caroline Bradley, Lecturer in Law at the London School of Economics, who gave us valuable assistance.

PART II

THE FACTUAL AND LEGAL CONTEXT

2.1 The purpose of this Part is to give a brief account of the factual and legal framework in which the issues with which we are concerned arise. It contains outlines of the structure of the modern financial conglomerate, the rules on the acquisition of knowledge by a firm, the relevant fiduciary duties and an overview of the principal regulatory structures relevant to our inquiry.

2.2 The Structure of the Modern Financial Conglomerate

2.2.1 The conflicts of interest and conflicting duties that arise from the nature of the organisational structure of a financial conglomerate are primarily attributable to three factors:

(i) the range of products and services provided by such a firm,

(ii) the composition of its customer base, and

(iii) the different capacities in which it conducts business.

In this section we shall identify the range of activities carried on by a financial conglomerate and the different capacities in which it acts. The major types of structural conflicts that arise are set out at paragraph 2.4.12.

2.2.2 It is first necessary to comment briefly on some of the problems identified with respect to the other professions covered by our terms of reference. We should distinguish difficulties in compliance with fiduciary obligations which necessarily arise from the structural organisation of a professional activity from difficulties that result from the fact that the professionals choose to carry on business in a way that may not comply with their fiduciary obligations. We have noted that the responses to the Issues Questionnaire indicated that some of the problems identified arose not as a result of the "conglomerate structure" of the particular profession, but as a consequence of the manner in which business was conducted.

2.2.3 Several examples have already been given in paragraph 1.9, above. Other examples are an estate agent being paid a commission for arranging an endowment policy for a customer and not making disclosure of this; or a valuer being retained by the estate agent department of the lender and who is under pressure because the lender for a number of commercial reasons wants to make the loan.[1] While these may be seen as acceptable trade practices by the profession in question and their prohibition or regulation might have consequences for the professionals involved, they are not attributable to the structure of the industry. They are simply situations where professionals for whatever reason carry on business in a manner which could cause conflict with standard fiduciary norms. None of the replies to our Questionnaire made the argument that in these situations there was a mismatch between fiduciary duties and regulatory rules or, for that matter, that the profession would have to adopt a different organisational structure were these practices to be prohibited. Accordingly, there is no need to deal with these situations in this section.

2.2.4 Conflicts arising from the organisational structure of an industry are most apparent in relation to the provision of financial services.[2] Professor Gower, in his *Review of Investor Protection*, referred to the wide range of services currently provided by a modern financial conglomerate. He instanced the case of a stock-broking firm that will have to be "knowledgeable about insurance policies, unit trusts and other types of managed funds and international and foreign securities as well as those listed on the Stock Exchange".[3] If firms acquire an expertise in these, Professor Gower continued, they will eventually put "clients into their own business[es]" and cut out any intermediaries.[4] As noted,[5] there are compelling commercial reasons why these various activities can be better carried on, and perhaps can only effectively be carried on, within a single firm.

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[1] Further examples are given in The Royal Institution of Chartered Surveyors, *Final Report on Conflicts of Interest* (June 1991).

[2] The potential structural difficulties arising from the amalgamation of law firms do not give rise to regulatory difficulty because the Law Society Professional Conduct Rules (see para. 5.3.33, below) require client consent where there is a conflict if the amalgamated firm is to continue to act.

2.2.5 A number of significant alterations to the structure of the financial services industry in the 1980s facilitated the type of financial conglomerate identified by Professor Gower.[6] One such reform was the abolition of the rules relating to outside ownership of members of the Stock Exchange. As a consequence, many Stock Exchange members were taken over, often by banks, to form part of a financial conglomerate which had the necessary resources to compete on the international scene.[7] The result of this was to proliferate further both the product range and the range of services offered by firms.[8] The second reform of importance was the abolition of single capacity whereby a person had to act as a stockbroker (an agent who acted on behalf of members of the public) or a jobber (a principal who made a market in securities for its own account).[9] Now members of the stock exchange are free to decide whether to act as a jobber, broker or both (dual capacity). Finally, fixed commission was abolished and stockbrokers were free to fix their own commission rates.

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[3] *Review of Investor Protection - A Discussion Document* (January 1982), at 59-60.

[4] *Ibid.*, at 60.

[5] Para. 1.1, above; para. 4.2.1, below.

[6] For a description of this phenomenon see Moran, *The Politics of the Financial Services Revolution (The US, UK and Japan) (1991)*, ch. 3; Clarke, *Regulating The City - Competition, Scandal and Reform (1986)*, at 170-177 ("Conflicts of interests in diversified organisations are endemic and only time can tell to what extent they can be prevented from having an adverse effect on clients", at 174). See further para. 1.1, above.

[7] The process of amalgamation into larger groups was also facilitated by the fact that in 1986 members of the Stock Exchange were permitted to carry on business as a limited company rather than as a partnership or an unlimited liability company: see Gower, "'Big Bang' and City Regulation", (1988) 51 M.L.R. 1. In 1987 it was estimated that of the 200 original member firms in existence before the introduction of the new membership rules more than half had become part of a larger grouping: see Bank of England Quarterly Bulletin, *Change in The Stock Exchange and Regulation of the City* (February 1987), at 54.

[8] "The ownership changes ... had repercussions across the whole of the UK financial sector, creating groupings which include associated or subsidiary firms active in securities dealing in the United Kingdom and abroad, in commercial and investment banking, in portfolio management, and in the marketing of investments" (Bank of England Quarterly Bulletin, *Change in The Stock Exchange and Regulation of the City* (February 1987), at 55).

2.2.6 The various reforms, as Professor Gower pointed out, had the consequence that a firm "may be faced with situations in which its interests while acting in one capacity conflict with those when it is acting in another".[10] There could also, of course, be conflicts between the duties which a firm owes to its different customers.[11] There is one other matter of importance in determining the extent and nature of the conflict caused by firms diversifying into a wide range of products and performing a range of different functions and that is the fact that one of the principal services provided by a firm is the exercise of discretionary control of customers' portfolios. Because a firm will often exercise such a wide discretionary control over its customers' affairs, it will be provided with ample opportunity to prefer its own interests to those of its customers, or to discriminate between customers.[12]

Types of Activities Carried On By a Firm

2.2.7 The range of activities carried on by a financial conglomerate and the different capacities in which it acts are illustrated by clause 30 of the Terms and Conditions for

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[9] Gower, "Big Bang and City Regulation", (1988) 51 M.L.R. 1, at 4-5. Cf. paras. 2.5.17-2.5.18, below for the introduction in 1982 into the Lloyd's market of a requirement that Lloyd's brokers divest themselves of interests in underwriting agencies.

[10] Gower, *Review of Investor Protection - A Discussion Document* (January 1982), at 60.

[11] Even as regards the same client difficulties can arise. For example, can a bank which acquires confidential information in connection with one transaction use it in connection with other unrelated transactions? This question was highlighted by the *Banking Services : Law and Practice Report by the Review Committee* (February 1989) (Chairman : Professor R.B. Jack), Cm. 622, paras. 5.12-5.14, 5.42. See also the Banking Code of Practice, *Good Banking* (December 1991), para. 6.2.

[12] Poser, *International Securities Regulation* (1991), at 183-184. This problem is accentuated by the fact that there is an increase in the range of financial products that are dealt with in the market: see, for an esoteric example, *City Index Ltd.* v. *Leslie* [1992] 1 Q.B. 98.

Discretionary Fund Management published by the Institutional Fund Managers' Association and the British Merchant Banking and Securities Houses Association:[13]

> "**30. Relationship** - The Manager and the Custodian each act as the agent of the Customer, who will therefore be bound by their acts under this Agreement. Nevertheless, none of the services to be provided hereunder nor any other matter shall give rise to any fiduciary or equitable duties which would prevent or hinder the Manager, the Custodian, or any Associate, in transactions with or for the Customer, acting as both market-maker and broker, principal or agent, dealing with other Associates and other customers, and generally effecting transactions as provided above."

2.2.8 The following is a brief description of activities carried on by a financial conglomerate:

(i) market maker A market maker is someone who holds himself out as being willing to provide a market in designated shares by entering into transactions of sale and purchase at prices determined by him generally and continuously rather than in respect of each particular transaction.[14] For extensively traded shares[15] there will invariably be more than one market maker but for less popular shares there may be only one market maker.

(ii) broker/dealer This is a person who buys and sells securities for customers. He will act as an agent for his customers but may also act as principal in his own right taking a position with respect to a security and selling it on to his customer. Often he will act for two customers in the same transaction matching the orders of the customers ("agency cross"), or buying shares from a selling customer and reselling immediately from his own book to a purchasing customer ("riskless principal" transaction).

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[13] Edition IFMA/BMBA2, 1991.

[14] For a definition of "market maker" see the Financial Services Glossary 1991 (2nd ed.), set out in Appendix 3. See also SFA Rulebook, 9.1; Company Securities (Insider Dealing) Act 1985, s. 3(1)(d) (as amended by FSA, s. 174).

[15] Shares are classified by normal market size (NMS), according to the liquidity of the stock. Previously they were classified as alpha, beta, gamma and delta. Alpha shares were the most liquid and the prices quoted on SEAQ have to be firm and the market makers must trade at those prices. The other classifications, particularly the gamma and the delta were much less liquid: see Lomax, *London Markets After The Financial Services Act* (1987), at 89-90.

(iii) asset management and customer advisory services A firm may act as a broker on an execution only basis, i.e. simply selling securities on the instructions of a customer. However, a firm will often carry on an advisory service advising customers with respect to transactions in securities. This advisory role may also be coupled with a discretion to alter a customer's investments without having to refer to the customer before the decision is made. Customers can vary from the unsophisticated individual to the sophisticated institutional investor. A firm will often have substantial funds under its control which it will handle on a discretionary basis.

(iv) corporate finance This covers financial advisory services provided for corporate customers, often listed companies, and thus the firm will obtain confidential information with respect to the company's listed securities. The range of services provided by the corporate advisory service will be varied but one such service is identifying potential targets for a customer planning to expand by means of acquisition.

(v) underwriting This covers the underwriting of new issues being offered to the public by the firm's corporate customers or rights issues.

(vi) unit trusts This covers services as a trustee or a manager of unit trusts[16] and operation of a unit trust scheme, through an associated company within the group.

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[16] It is not permissible for the role of manager and trustee to be vested in the same person: see FSA, s. 78(2); Art. 10 of the UCITS Directive (85/611/EEC). See also FSA, s. 83(1) & (2).

2.2.9 Capacity in which a firm deals As is clear from what has been said above, a firm will often deal as an agent or in its own right.[17]

2.3 Acquisition of Knowledge By a Firm

2.3.1 The issue addressed in this section is that of how a firm acquires knowledge and how it forgets. This is obviously relevant to the process by which information, although located in only one part of the firm, will be treated as being known to the firm as an "entity" and therefore to all persons who act for the firm. It will be assumed that the firm is a single company. The problem of groups of companies is dealt with in paragraphs 2.3.8-2.3.9 and partnerships in paragraph 2.3.10.

Attribution and the Acquisition of Knowledge in a Single Legal Entity

2.3.2 It is a commonplace observation that a company can only act through an agent or officer.[18] The question thus inevitably arises as to when a company will be deemed to know what its agent or officer knows and when the agent or officer will know what the company knows? In determining how a firm "knows" there are two different techniques adopted in the cases. The first is to attribute directly to the firm knowledge possessed by one of its officers or agents and the second is to follow the normal doctrines of agency. In many situations these approaches will produce the same result and, therefore, it would be a matter of indifference which approach was adopted. However, the distinction between these approaches is of importance where for liability to be imposed the person to be held liable must possess a particular mental state and it is not possible for a person to be deemed to have this state by vicarious means.

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[17] There are certain markets in which its members can only trade as principals, for example, the financial futures market. See para. 2.4.7, below.

[18] "A company is an artificial person, and so the knowledge of the natural persons who control and manage it must be treated as being the knowledge of the company; but that is no ground for saying that the knowledge of one natural person must be treated as being the knowledge of another": *per* Sir Robert Megarry V.-C., *In re Montagu's Settlement Trusts* [1987] Ch. 264, 283.

Attribution[19]

2.3.3 As regards attribution, there are two broad approaches reflected in the cases.[20] The first, referred to as the "functional" approach, involves determining what is the purpose of a finding of knowledge on the part of the company and from this "tailoring to the purpose in hand the net of human persons whose knowledge will be ascribed to the company".[21] The other has been described as a more "metaphysical" approach in that the court attempts to identify who is the "brain or nerve centre" of the company and the knowledge of that person is attributed to the company.[22] There is a wide range of situations where the issue of a company's knowledge and mental acts arises and where attribution is of importance because liability can only be imposed on the person who carries out, or who authorises the carrying out, of a particular transaction. For example, how and what does a company "know" for the purpose of answering interrogatories and, in this context, can a company forget?[23] How does a statutory provision which applies only to acts that are committed with "fault or privity" apply to a company?[24] Does a company and all persons who act on its behalf "know" of information that is stored with the company? How does a transport company "permit" an employee to drive for excessive periods of time in violation of relevant road traffic legislation?[25] How does a company form the necessary *mens rea* for the commission of a crime?[26] By what mechanism of attribution can a company be held to be in contempt of a court order that has been made against it?[27] Questions involving a company's "purpose" can also arise under legislation.[28] Although there is a certain penumbra of doubt,[29] generally speaking a company will have attributed to it the acts of officers who have a managerial responsibility for carrying out or controlling the particular activity in question and the officer is acting in the course of carrying out his functions.[30] However, since agency doctrines can operate to treat a company as possessing knowledge possessed by its agent, the principle of attribution normally does not have to be invoked in order to find corporate knowledge.

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[19] See generally, Leigh, *The Criminal Liability of Corporations in English Law* (1969), Ch. 7.

[20] See Gower, *Principles of Modern Company Law* (4th ed., 1979), at 205-213.

[21] Wedderburn, "When Does a Corporation Forget?", (1984) 47 M.L.R. 345 at 345.

[22] See Wedderburn, *op. cit.*, at 346. This is the metaphor of Denning L.J. in *Bolton (Eng.) Co. Ltd.* v. *Graham & Sons Ltd.* [1957] 1 Q.B. 159, 172-173. The authorities on attribution for the purpose of criminal liability are collected in *Criminal Liability Of Corporations* (1972), Law Commission Working Paper No. 44.

[23] *Stanfield Properties Ltd.* v. *National Westminster Bank Plc.* [1983] 1 W.L.R. 568.

[24] *Lennard's Carrying Co. Ltd.* v. *Asiatic Petroleum Co. Ltd.* [1915] A.C. 705 dealing with liability under the Merchant Shipping Act 1894, s. 502 (now repealed, but see Merchant Shipping Act 1979, s. 18) whereby the owner of a ship could be exonerated from liability for damage caused by the ship if this occurred without the "actual fault or privity" of the owner. For other relevant authorities on this see Gower, *Principles of Modern Company Law* (4th ed., 1979), at 205-206.

Agency

2.3.4 Most of the problems of determining what knowledge is possessed by a firm are dealt with by the standard principles of agency. A firm, as principal, will normally be treated as possessing the knowledge that is possessed by its agents and officers which it is the responsibility of these agents and officers to acquire or receive on behalf of the firm and communicate to it.[31] The consequence of this is that as regards any particular act or transaction a firm will be deemed to know the information which has been acquired by its agents or officers within the scope of their authority in connection with that act or transaction. There is some slender authority for the proposition that a principal will be held to have notice of matters acquired by an agent in a previous transaction.[32] It is important to note that the cases dealing with the circumstances where a principal will be deemed to possess knowledge known to his agent were decided in an era when business structures and information storage and retrieval systems were infinitely more simple. There is no reason for assuming, however, that the more complex and sophisticated contemporary commercial structures would lead to a different result as to when a firm would be treated as having knowledge of matters known by its agent.

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[25] *Worthy* v. *Gordon Plant (Services) Ltd.* (Note) [1989] R.T.R. 7.

[26] *Tesco Supermarkets Ltd.* v. *Nattrass* [1972] A.C. 153.

[27] *Re Supply of Ready Mixed Concrete* [1991] 3 W.L.R. 707.

[28] See, for example, Companies Act 1985, s. 153(2)(a) (determination of a company's "principal purpose").

[29] See *Criminal Liability of Corporations* (1972), Law Commission Working Paper No. 44.

[30] *The Lady Gwendolen* [1965] P. 294.

[31] Bowstead, *The Law of Agency* (15th ed., 1985), Article 102, at 412-420.

Forgetting

2.3.5 There is no authority which deals comprehensively with the question of whether a firm can forget and, if so, how.[33] It would be driving the concept of knowledge to absurd lengths to hold that "once known never forgotten",[34] but what seems to be tolerably clear is that if a company can forget the court will hold that there has been corporate amnesia only in exceptional circumstances.[35] The reasons for this are twofold, the first practical, the second one of policy: (a) modern electronic systems of information storage and retrieval make it relatively easy for a firm to store and recall information; (b) a wide doctrine recognising corporate loss of memory would provide firms with a perverse incentive to organise their affairs to bring about ignorance. Accordingly, it will be seldom that a firm can safely rely on the argument that it should be treated as having forgotten relevant information which is stored in its records.

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[32] See *Dresser* v. *Norwood* (1864) 17 C.B. N.S. 466 (arguably in this case the agent was made aware of the relevant facts at the time of entering into the transaction); *Turton* v. *London & Northwestern Rly. Co.* (1850) 15 L.T.O.S. 92; *Taylor* v. *Yorkshire Insurance Co. Ltd.* [1913] 2 I.R. 1, 21-22; Powell, *The Law of Agency* (2nd ed., 1961), at 242-243. There are special rules with respect to knowledge deemed to be acquired by purchasers of land: see para. 2.3.11, below.

[33] It was a concern with "forgetting" that led the courts in some cases to hold that normally knowledge acquired by an agent in a previous transaction for another principal should not be attributed to the principal for which he is presently acting: see *Fuller* v. *Bennett* (1843) 2 Hare 394.

[34] See *Re Montagu's Settlement Trusts* [1987] Ch. 264, 284 where Sir Robert Megarry held that a person would not be treated as having knowledge of something that he had genuinely forgotten. See also, *Ipswich Permanent Money Club Ltd.* v. *Arthy* [1920] 2 Ch. 257.

[35] See *Bates* v. *Stone Parish Council* [1954] 1 W.L.R. 1249 (council deemed to know something that had occurred sixteen years earlier which had been recorded in its minutes and where the council had two members still serving as councillors who were councillors when the event occurred); *Houghton & Co* v. *Northard Lowe & Wills Ltd.* [1928] A.C. 1, 18 (company not deemed automatically to know everything that appears in its ledgers where this information is not known to the directors).

Extent to Which Knowledge Known By One Part of the Firm is Known By Another Part

2.3.6 Where the firm is a company, then as a matter of principle any matter known by part of the firm would be known by all parts of the firm; it is difficult to see any legal basis for holding that there is "partial ignorance". There is clear authority for this proposition. In *Harrods Ltd.* v. *Lemon*[36] information possessed by a trading company's estate agency department and its building construction department, which were physically separated, was pooled and treated as one. Likewise in *Lloyds Bank Ltd.* v. *EB Savory & Co.*[37] information possessed by one branch of a bank was held to be possessed by another branch of the bank with the consequence that the bank was held to be in breach of its duty to its customer. A similar conclusion had been reached in other Commonwealth jurisdictions.[38]

2.3.7 *Armstrong* v. *Strain*[39] might be considered authority for a different rule since the court was not willing to pool the knowledge of an agent and a principal so as to find that a fraudulent misrepresentation had been made by the agent in connection with the sale of property. However, this case is clearly distinguishable from the authorities in favour of the pooling of information held by different agents or parts of a firm. *Armstrong* was a case of fraud and the courts are reluctant to find fraud unless dishonesty is proven. There is authority that where the issue is a breach of warranty then knowledge can be pooled.[40] Also, *Armstrong* involved the relationship between a vendor and purchaser, a strictly commercial relationship, whereas the other authorities under discussion involved a relationship with a customer, something which can give rise to more extensive obligations.[41] It is also of relevance to note that Core Rule 36(3) must have been drafted on the assumption that the knowledge of one part of the firm could be attributed to an agent who is acting on behalf of the firm.[42]

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[36] [1931] 2 K.B. 157.

[37] [1933] A.C. 201. The bank argued that the system it had adopted for the clearance of cheques involved a division of knowledge and therefore the knowledge at its separate branches should not be pooled. To this Lord Wright replied: "In my judgment, as a matter of law, the system can in this case be disregarded, because I hold that the Bank cannot in virtue of that system which it voluntarily adopts, no doubt for general convenience and in the general interest of its customers, put itself in any better position than if the cheques had all been paid into the one branch: the Bank cannot in that way claim to have split up its knowledge" (at 235). Cf. *Barclays Bank* v. *Khaira* The Times, 19 December 1991.

[38] *Standard Investments Ltd.* v. *Canadian Imperial Bank of Commerce* (1986) 22 D.L.R. (4d) 410; *Comeau* v. *Canada Permanent Trust Co.* (1980) 27 N.B.R. (2d) 126; Austin, "The Corporate Fiduciary '*Standard Investments Ltd.* v. *Canadian Imperial Bank of Commerce*'", (1986-87) 12 C.B.L.J. 96; Ziegel, "Bankers' Fiduciary Obligations and Chinese Walls: a further comment on *Standard Investments Ltd.* v. *Canadian Imperial Bank of Commerce*", (1986-87) 12 C.B.L.J. 211; Crawford, "Bankers' Fiduciary Duties and Negligence", (1986-87) 12 C.B.L.J. 145 at 155-161.

[39] [1952] 1 K.B. 232.

The Firm as a Group

2.3.8 It is a firmly established principle of company law that companies are separate legal entities and that even a wholly owned subsidiary is a separate legal entity from its parent.[43] It therefore follows that the knowledge possessed by one entity within a group will not be attributed to another entity which is part of the group. There is no reason in principle why this rule should not apply in all its vigour to financial conglomerates. Thus it has been held that documents in possession of a wholly owned subsidiary which the directors of the subsidiary refused to hand over to the parent company were not within the "possession, custody or power" of the parent for the purpose of RSC, Ord. 24.[44] In certain rare situations the court is willing to pierce the corporate veil and such a process could be used to attribute to different companies within a group knowledge that is possessed by other companies. But this process is normally only invoked when the corporate entity doctrine is being used for some self-evidently improper purpose[45] and, therefore, since it is invoked to deal with abuse about which there could be little doubt, it will not give rise to any regulatory problems.

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[40] *Efploia Shipping Corporation Ltd.* v. *Canadian Transport Co. Ltd. (The Pantanassa)* [1958] 2 Lloyd's Rep. 449, 456-457; Atiyah, *Vicarious Liability in the Law of Torts* (1967), at 188-190, 272-273.

[41] There is a dictum in the judgment of Singleton L.J. in *Armstrong* (at 244) about difficulties that could arise where a corporate officer makes a statement which another officer knows to be fraudulent. Too much should not be made of this since he still appears to require that the officer making the statement be guilty of fraud even though he would appear to be willing to consider that the court could draw this inference from the fact that the officer did not know all the facts. See, however, Gower, "Agency and Fraud", (1952) 15 M.L.R. 232, at 235. Also an authority slightly in favour of the pooling of knowledge to find fraud does not appear to have been cited to the court in *Armstrong*: see *Woyka and Co.* v. *London and Northern Trading Co.* (1922) 10 L.L.Rep. 110, 115; Clerk and Lindsell, *Torts* (16th ed., 1989), at paras. 18-29.

[42] Set out in Appendix 3, below. See also Finn, "Fiduciary law and the Modern Commercial World", Norton Rose Oxford Law Colloquium (September 1991).

[43] See Gower, *Principles of Modern Company Law* (4th ed., 1979), ch. 6; *National Dock Labour Board* v. *Pinn & Wheeler Ltd.* [1989] B.C.L.C. 647; *Adams* v. *Cape Industries Ltd.* [1991] 2 W.L.R. 657; *J.H. Rayner (Mincing Lane) Ltd.* v. *Department of Trade and Industry* [1990] 2 A.C. 418, 482, 506.

2.3.9 In paragraph 4.5.23, in dealing with Chinese walls, the practice referred to as "overlooking the wall" is described. In this situation, for example, a director of a subsidiary may also sit on the board of its parent company. The issue arises as to whether the knowledge acquired by a person when acting as a director of one entity within a group will be attributed to another entity when he is acting for it. The answer to this depends on whether the director is under an obligation to communicate the information to either entity.[46] If he is not under such an obligation, there will be no attribution. Thus it lies within the powers of the companies to organise their affairs so that attribution will not operate. However, where a director is put in a position to overlook a Chinese wall for the purpose of discharging his responsibilities as a member of the parent company's board, it will be difficult (if not impossible) for a firm to organise its affairs so as not to be deemed to possess the knowledge possessed by a director who overlooks the wall.

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[44] *Lonhro Ltd.* v. *Shell Petroleum Co. Ltd.* [1980] Q.B. 358-5. See also *Bank of Tokyo* v. *Karoon* (Note) [1987] A.C. 45.

[45] See Gower, *op. cit.*, ch. 6.

[46] See *Re David Payne & Co. Ltd.* [1904] 2 Ch. 608; *Re Fenwick, Stobart & Co. Ltd.* [1902] 1 Ch. 507. See also other cases in Bowstead, *op. cit.*, at 419, nn. 41 and 42.

Partnerships

2.3.10 Notice to one partner of any matter relating to the affairs of the partnership will normally be imputed to the other partners.[47] The solicitor cases would appear to qualify the breadth of this rule at least where the firm has established arrangements to prevent knowledge from being communicated from one partner to others within the firm.[48]

Legislative Alteration of the Attribution Rule

2.3.11 We have not been able to identify a significant number of occasions on which the attribution rules have been modified by statute so that persons are treated as being ignorant in circumstances in which, but for the legislation, they would be deemed to have knowledge. The examples we have found[49] are:

(i) Law of Property Act 1925, section 199(1)(ii)(b): A purchaser will only be deemed to have the knowledge of his counsel, solicitor, or other agent which the latter acquires in the *particular* transaction in which he is acting for the purchaser.[50]

(ii) Trustee Act 1925, section 28: A trustee or personal representative who acts for more than one trust or estate will not be deemed to have notice of matters acquired from dealing for one trust or estate when dealing with the affairs of another trust or estate.

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[47] Partnership Act 1890, s. 16. This does not apply in the case of fraud. See generally, *Lindley and Banks on Partnership* (16th ed.,1990), at 256-258.

[48] See paras. 4.5.7-4.5.10, below.

[49] See also FSA, s. 44(8); Land Registration Act 1925, s. 74; Law of Property Act 1925, s. 94(2).

[50] For the background to this provision see *Taylor* v. *Yorkshire Insurance Co.* [1913] 2 I.R. 1.

(iii) Companies Act 1989, section 108(1) introducing a new section 35A into the Companies Act 1985: Section 35A provides that, in favour of any person dealing with a company in good faith, the power of the board of directors shall be deemed to be free of any limitation under the company's constitution. "Good faith" is partially defined in section 35A(2)(b) to provide that a person will not be treated as acting in bad faith by "reason only of his knowing that an act is beyond the powers of the directors under the company's constitution". This means that if a person dealing with the directors has attributed to him knowledge that they are acting beyond their powers[51] this by itself is not evidence of bad faith.[52]

We would be grateful for other examples of statutory treatment of attributed notice or knowledge.

2.4 Outline of Fiduciary Duties[53]

2.4.1 We now turn to fiduciary law. In this section we seek to outline the position in relation to two questions, who is a fiduciary and what duties does a fiduciary have? This area of the law is highly complex, poorly delimited, and in a state of flux. This is not necessarily a criticism and courts and commentators have supported the current state of the subject. Some have said that attempts at a definition are unwise or inappropriate,[54] while others have pointed to the open-ended and prophylactic nature of the fiduciary concept, which necessarily defies definition.[55] It is unclear at the present time whether the term "fiduciary" "has generally been descriptive, providing a veil behind which individual rules and principles have been developed",[56] or whether the case law evidences the steady development of the fiduciary concept towards an all-embracing general principle.

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[51] For example, where a bank manager is treated as knowing that the act is beyond the board's powers because a copy of the company's constitution is held by the bank.

[52] This provision is necessary in order to comply with Article 9(2) of the First Directive (68/15/EEC).

[53] See generally Finn, *Fiduciary Obligations* (1977).

[54] Goff and Jones, *The Law of Restitution* (3rd ed., 1986), at 632; *Lloyds Bank Ltd.* v. *Bundy* [1975] Q.B. 326, 347, *per* Sir Eric Sachs; *Re Craig, decd.* [1971] Ch. 95, 104, *per* Ungoed-Thomas J.

2.4.2 Much of this uncertainty is the result of the historical development of the subject from disparate areas. The classic examples of fiduciary relationship, such as trustee-beneficiary and agent-principal relationships, involved duties which were based on the particular circumstances of the relationship. Later development of the general area of fiduciary duties has led to the application of rules developed in particular contexts to the general class of fiduciary relationship.[57] It is thus not surprising that the area of fiduciary duties has provided fertile ground for a variety of different approaches.[58] In the brief outline which we provide in this section it is not possible to consider this area of law in the depth with which many commentators have looked at it. Therefore, this outline is intended as just that, an outline for the purposes of this paper. It is not intended to add further to the debate surrounding this subject.

Who Is a Fiduciary?

2.4.3 Although the combination of equity's broad approach and its insistence on examining the particular fact situation means that categorisation in this area can only be used with caution, for expository purposes, it is possible to divide fiduciaries into two categories, status-based fiduciaries and fact-based fiduciaries.[59] English cases have mainly concerned status-based fiduciaries. These include people who by virtue of their involvement in certain relationships are considered, without further inquiry, to be fiduciaries. Such relationships include those between trustee-beneficiary, solicitor-client, agent-principal, director-company, and partner-partner. While some of the relationships involve power to act on behalf of another, there has been no clear, universal test accepted in the cases for classifying these particular relationships as fiduciary.[60] It would appear that each of the relationships is of such importance and of such a nature that it needs protection by the imposition of fiduciary status.[61]

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[55] *Laskin* v. *Bache & Co.* (1971) 23 D.L.R. (3d) 385, 392, *per* Arnup J.A.; Sealy, "Some Principles of Fiduciary Obligation", [1963] C.L.J. 119 at 135; *Canadian Aero Service Ltd.* v. *O'Malley* (1974) 40 D.L.R. (3d) 371, 383; *English* v. *Dedham Vale Properties Ltd.* [1978] 1 W.L.R. 93.

[56] Finn, *op. cit.*, para. 2.

[57] See generally Shepherd, *Law of Fiduciaries* (1981), ch.1.

[58] See, for example, Finn, *op. cit.*; Shepherd, *op. cit.*

2.4.4 The second category, fact-based fiduciaries, has received less consideration by English Courts. It is generally accepted that a person may be a fiduciary although he does not fall within any of the classes of status-based fiduciaries. Here the fiduciary duties are incurred because of the factual situation of the particular relationship.

2.4.5 In *Reading* v. *Attorney-General*,[62] which concerned the entitlement of an army sergeant to sums received as bribes for escorting smugglers' lorries through police checks while wearing his military uniform, Asquith L.J., giving the judgment of the Court of Appeal, said that in such cases:

> "... the term 'fiduciary relation' ... is used in a very loose, or at all events a very comprehensive, sense .... [F]or the present purpose a 'fiduciary relation' exists (a) whenever the plaintiff entrusts to the defendant property, including intangible property as, for instance, confidential information, and relies on the

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[59] This distinction is used by Flannigan although in a slightly different manner, "The Fiduciary Obligation", [1989] 9 O.J.L.S. 285.

[60] It was justified in *Welles* v. *Middleton*, (1784) 1 Cox 112, 124-5, as necessary for the "preservation of mankind".

[61] See paragraph 2.4.9, below.

[62] [1949] 2 K.B. 232; on appeal [1951] A.C. 507.

> defendant to deal with such property for the benefit of the plaintiff or for purposes authorised by him, and not otherwise ... and (b) whenever the plaintiff entrusts to the defendant a job to be performed, for instance, the negotiation of a contract on his behalf or for his benefit and relies on the defendant to procure for the plaintiff the best terms available ..."[63]

In the wide sense in which the term was used, the Court considered that a fiduciary relationship subsisted in the case "as to the user of the uniform and the opportunities and facilities attached to it".[64] Although this decision has attracted much criticism,[65] and it has been suggested that it leads to the status of fiduciary, in such circumstances, being easily acquired,[66] it illustrates that courts may hold a relationship to be fiduciary *for some purposes* where they feel it is proper to do so.

2.4.6 There has also been consideration of fact-based fiduciary relationships in other Commonwealth jurisdictions. Two cases are of particular importance, *Hospital Products Ltd.* v. *United States Surgical Corporation*[67] (concerning the relationship between a manufacturer and a distributor which, on the facts, the High Court of Australia held was not fiduciary), and *Lac Minerals Ltd.* v. *International Corona Resources Ltd.*[68] (concerning the relationship of the parties to a joint venture which, on the facts, the Supreme Court of Canada held was fiduciary). In both these cases the relationships between the parties did not fall within any of the classes which give rise to a status-based fiduciary relationship, commercial relationships generally being considered not to give rise to fiduciary duties. However, it was still considered that the presence of certain factors in a relationship would give rise to fiduciary obligations. The factors included an undertaking by the fiduciary to act on behalf of or for the benefit of another person, a discretion or power which affects the interest of that other person, and the peculiar vulnerability of that other person to the fiduciary. This vulnerability can be shown by factors such as dependence upon information and advice, the existence of a relationship of confidence and the significance of a particular transaction for the parties.[69] This test is based on discretion, power to act and vulnerability. Even if it is not possible to lay down a general test as to when a fiduciary relationship will arise,[70] this provides the basis of a test for fact-based fiduciary relationships.

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[63] [1949] 2 K.B. 232, 236, reasoning approved by the House of Lords, [1951] A.C. 507.

[64] [1949] 2 K.B. 232, 238.

[65] E.g. Finn, *op. cit.* para. 498. Cf. Meagher, Gummow & Lehane, *Equity Doctrines and Remedies* (2nd ed., 1984), para. 524.

[66] Goff and Jones, *The Law of Restitution* (3rd ed., 1986), at 655.

[67] (1984-5) 156 C.L.R. 41.

[68] [1989] 2 S.C.R. 574.

2.4.7 In applying the status-based and fact-based tests to the financial services area it is evident that in general a firm advising a customer or making purchases on a customers behalf will be acting in a fiduciary capacity. A firm will generally act as an agent transacting "for or on behalf of its customer", and thus fall within the status-based class of fiduciary. However, if an exchange has rules which provide that people dealing on that exchange must deal as principals, the situation becomes more complex. In this situation no privity of contract is established between a firm's customer and the person with whom the firm executes the transaction. Instead, two contracts are brought into existence, one between the firm and its customer, the other between the firm and the person with whom it executes the transaction. It has been argued that because of these "back to back" contracts the firm must be acting as principal in relation to its customer,[71] although the general approach of the courts has been to find that the firm acted as agent until it made the transaction on the exchange, and from that point on it acted as principal in relation to its customer.[72] Whether or not the relationship is labelled as that between principal and agent or that between two principals, a fiduciary relationship will still be brought into existence if the relationship comes within the class of fact-based fiduciary relationships. It is our view that the relationship between a firm and its customer in the situation outlined above will come within this class.

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[69] *Coleman* v. *Myers* [1977] 2 N.Z.L.R. 225, 325, *per* Woodhouse J. See also *Coleman v. Myers*, 330, 371; *Re Chez Nico (Restaurants) Ltd.* [1991] B.C.C. 736, 750; Finn, *op. cit.*, para. 467.

[70] *Coleman* v. *Myers*, above, 325.

[71] For example, see the argument of Mr. Yorke, Q.C., as discussed by Kerr J. in *Bailey (E) & Co.* v. *Balholm Securities* [1973] 2 Lloyd's Rep. 404, 408.

[72] *Bailey & Co.* v. *Balholm Securities*, *ibid.*, 408; *Limako B.V.* v. *H. Hentz & Co. Inc.*, [1979] 2 Lloyd's Rep. 23, 27.

The Nature and Scope of Fiduciary Duties

2.4.8 It is clear that the scope of the duties of a fiduciary vary depending upon the nature of the relationship. As Fletcher-Moulton L.J. said in *Re Coomber*:[73]

> "Fiduciary relations are of many different types; they extend from the relation of myself to an errand boy who is bound to bring me back my change up to the most intimate and confidential relations which can possibly exist between one party and another where the one is wholly in the hands of the other because of his infinite trust in him. All these are cases of fiduciary relations, and the Courts have again and again, in cases where there has been a fiduciary relation, interfered and set aside acts which, between persons in a wholly independent position, would have been perfectly valid. Thereupon in some minds there arises the idea that if there is any fiduciary relation whatever any of these types of interference is warranted by it. They conclude that every kind of fiduciary relation justifies every kind of interference. Of course that is absurd. The nature of the fiduciary relation must be such that it justifies the interference. There is no class of case in which one ought more carefully to bear in mind the facts of the case, when one reads the judgment of the Court on those facts, than cases which relate to fiduciary and confidential relations and the action of the Court with regard to them."

Thus, the precise scope of the obligations enforced is dependent on the scope of the duties undertaken. If a person is a status-based fiduciary it would appear that his fiduciary obligations apply to all activities[74] that occur within the scope of that relationship, and any opportunities that arise as the result of that relationship. What is important, however, is the scope of the relationship.[75] It is probable that in the case of a fact-based fiduciary the obligations imposed will be more limited. The reasoning by which a fiduciary relationship was imposed on the facts can be used to limit the fiduciary obligations to activities which result from the discretion available, and play upon the vulnerability of the beneficiary.

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[73] [1911] 1 Ch. 723, 728-9.

[74] The scope is very wide reaching, see *Boardman* v. *Phipps* [1967] 2 A.C. 46; *Industrial Development Consultants Ltd.* v. *Cooley* [1972] 1 W.L.R. 443.

2.4.9 Although the scope of a fiduciary's obligations is fluid, the nature of the duties owed is reasonably clear.[76] The duties may be summarised in several different ways. In the Issues Questionnaire, published prior to this paper, we adopted the following four point approach:

(i) the "no conflict" rule A fiduciary must not place himself in a position where his own interest conflicts with that of his customer, the beneficiary. There must be a "real sensible possibility of conflict";[77]

(ii) the "no profit" rule A fiduciary must not profit from his position at the expense of his customer, the beneficiary;

(iii) the undivided loyalty rule A fiduciary owes undivided loyalty to his customer, the beneficiary, and therefore must not place himself in a position where this duty towards one customer conflicts with a duty that he owes to another customer. A consequence of this duty is that a fiduciary must make available to a customer all the information that is relevant to the customer's affairs;

(iv) the duty of confidentiality A fiduciary must use information obtained in confidence from his customer, the beneficiary, for the benefit of the customer and must not use it for his own advantage or for the benefit of any other person.

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[75] *Re a Solicitor* (1987) 131 S.J. 1063, *per* Hoffmann J.

[76] Meagher, Gummow, Lehane, *op. cit.*, para. 504.

[77] *Boardman* v. *Phipps* [1967] 2 A.C. 46, 124, *per* Lord Upjohn. See also *Queensland Mines Ltd.* v. *Hudson* (1978) 52 A.L.J.R. 399 (P.C.); Finn, *op. cit.*, paras. 582, 567.

2.4.10 The various forms of fiduciary duty which may be incurred by a firm can be developed from these basic rules. The consequences of breach vary according to the particular circumstances. At one extreme, where the fiduciary buys or sells the beneficiary's property on his own account the transaction is voidable by the beneficiary as of right however fair the transaction.[78] In other cases where these duties are breached, the fiduciary may be required to account for profits he has made by virtue of his position or by his use of the beneficiary's property. But even where the transaction is set aside, it may be on terms which include reasonable remuneration for work done by the fiduciary.[79]

2.4.11 It must be noted that fiduciary duties may be modified by agreement or the acquiescence of the beneficiaries, and this is considered in Part III of the paper. As the exact nature of fiduciary duties varies between relationships, we shall consider the fiduciary duties that can be incurred in the relationships that are of relevance in the present context. The various relationships, and forms of conflict and potential breach set out below, all assume that a fiduciary duty is owed and that it has not been modified.

Examples of Conflict within Conglomerates[80]

2.4.12 Before considering the specific relationships in which breach might occur we set out some of the conflicts that could arise with respect to a firm which is a financial conglomerate. It is important to reiterate[81] that we are assuming that firms are following best market practice. Where firms do not follow best practice but are tempted to serve interests other than those of the customer for whom they are acting, the possibility of conflict and breach of duty is greatly increased.[82] The following examples are illustrative and should not be taken as being exhaustive of the types of conflict that can arise from the conglomerate structure of a firm:

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[78] *Tito* v. *Waddell (No. 2)* [1977] Ch. 106; *Re Thompson's Settlement* [1986] Ch. 99.

[79] *O'Sullivan* v. *Management Agency and Music Ltd.* [1985] Q.B. 428.

[80] A list of these can be found in Poser, *International Securities Regulation* (1991), at 186-187; Wood, "Financial Conglomerates and Conflicts of Interest" in *Conflicts of Interest in the Changing Financial World* (1986) (ed. Goode), at 59.

[81] See para. 1.12, above.

(i) Dealing off one's book or buying on one's own account This refers to the activity of a firm selling its own property (whether it be stock or otherwise) to an advisory or discretionary customer or buying the property of such a customer.[83] There will be a conflict between the firm's and the customer's interests (the vendor being interested in obtaining the highest price obtainable, the purchaser the lowest). This may also breach the "no profit" rule, although if the firm has made a loss on its transaction, (for example if the stock has fallen in value since the firm purchased it), the remedial consequences are rather complex.

(ii) Matching orders and riskless principal transactions A firm owes undivided loyalty to its customer, and it cannot give such loyalty if it is acting for both parties to a transaction as where it executes an agency cross or a riskless principal transaction.

(iii) Dealing in property in which the customer has an interest This conflict is not very clear cut. A fiduciary's interest must not conflict with that of his customer. It may be that if a firm has an interest in property in which the customer also has an interest their respective interests will conflict. For example, if both the customer and the firm have large share-holdings in a company any disposal by the firm from either the customer's or his own holding may well affect the value of their respective holdings.

(iv) Preferential or discriminatory treatment A firm in showing undivided loyalty must treat customers to whom it owes similar duties equally, and cannot prefer one of them to any other. Thus, if it becomes aware of an investment opportunity, and only advises some of its customers of the opportunity, it will be in breach of its duty. Other conflicts may arise where the corporate finance department is underwriting a share issue which is being recommended by its broker/dealer department. In allocating the shares being underwritten, the corporate finance department may treat some customers more generously than others or, if the issue is not a success, it may persuade the broker/dealer department to purchase shares for discretionary managed accounts. Again, where a broker/dealer aggregates orders this could result in a customer not obtaining a better price which could have been obtained if the order had been executed immediately. Finally, where a firm manages two unit trusts, one, for example, a general European trust and the other restricted to a particular country, there will be difficulties in determining how investment opportunities in the particular country are to be allocated between the funds.

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[82] See Poser, "Chinese Wall or Emperor's New Clothes? (1)", (1988) 9 Co. Law. 119, at 120-121.

[83] On the duties of the firm where the broker/dealer acts in an execution only capacity, see para. 2.4.14(iii), below.

(v) Failure to utilise all the information available A firm must utilise all the information available to it when acting for a customer. Due to attribution of knowledge within a firm, all parts of the firm must act in the light of all information possessed by the firm.[84] This gives rise to a number of difficult problems. For example, the broker/dealer department may be advising customers to purchase shares in a company advised by the corporate finance department which the latter knows, but the broker/dealer department does not know, is on the verge of insolvency. Here the customer is not being provided with the benefit of all the relevant information in the firm's possession and, coupled with this, the broker/dealer department will obtain commission from any purchase order executed for a customer. Another example is where the broker/dealer department is instructed to purchase a substantial holding in a listed company (say 2% of the shares in a major plc) at the end of the trading day and, before it carries out its instructions, an advisory customer seeks advice as to whether he should sell shares in the relevant company. This raises the

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84. On attribution of knowledge within a firm, see Section 2.3, above.

issue as to whether the customer seeking advice is entitled to be informed of the purchase instruction and, if not, what is the correct way for the firm to respond to the request.

(vi) Breach of Confidentiality A firm must not utilise information obtained from a customer in confidence other than for the purposes of that customer. This means that a firm will often find itself in the situation where it will inevitably breach its duty to one or other of its customers. It will breach its duty to the confiding customer if it uses the information for another customer, but will breach its duty to the other customer if it fails to use the information obtained from the confiding customer on that other customer's behalf.

(vii) Self-dealing on the basis of confidential information As attribution of knowledge occurs throughout a firm problems will occur if a firm is dealing on its own account in a product about which some part of the firm has relevant price-sensitive confidential information.

(viii) Take over situations The commercial bank within a group may be advising the target of a hostile bid while the corporate advisory department in the group may be advising the bidder. If these separate entities are treated as one, there would be an obvious conflict of duties. Secondly, the corporate finance department may be advising a customer with respect to a rumoured bid from an anonymous bidder who, when it reveals its identity, turns out to be a former customer of the firm. Thirdly, the department managing discretionary accounts is selling the shares of a company which is making a hostile share exchange takeover and is being advised by the firm's corporate advisory department. The sale of the shares could have the effect of depressing the offeror company's share price with the obvious consequences that this entails for the success of the bid.

Trustees

2.4.13 Firms may act as corporate trustees for private trusts or for unit trusts. As such they are trustees of the fund for the benefit of the beneficiaries, and are subject to the widest range of fiduciary duties. Thus, in the absence of an effective variation of the duty, the self-dealing rule is applied strictly to trustees and they may not buy trust property themselves or sell their own property to the trust. These rules apply even if they are selling or buying at competitive market prices, the courts strictly prohibiting any possible conflict between the interests of the trustees and beneficiaries. The same degree of strictness is also applied where a trustee takes an interest in property in which the trust has an interest.

Agents

2.4.14 These can be divided into three classes, general agents, advice only agents, and execution only agents. These are not terms of art and the precise breaches of duty for which an agent might be liable will depend on the precise scope of the particular relationship he has with a customer.

(i) General Agents (including discretionary fund managers) General agents will be bound by all the rules listed above.

(ii) Advice only Agents Advice only agents will not deal on behalf of the customer and therefore they will not be able to act by dealing off their own book, utilising the professional services of their own firm, or matching orders. They will, however, be in breach if they give some of their customers preferential treatment, fail to utilise information available to them, breach the confidentiality of their customers, or self-deal on the basis of confidential information.

(iii) Execution only Agents The duties of these agents are limited because they do not give advice. If a firm acts as an execution-only agent, duties to provide information and advice fall outside the scope of its relationship with the customer. Where a broker/dealer acts in an execution only capacity the firm does not normally owe fiduciary duties to the customer in relation to the transaction itself.

Solicitors

2.4.15 Solicitors are subject to the same duties as trustees in relation to confidentiality and dealings with customers' property. Solicitors must exercise the utmost good faith, give customers disinterested advice and make full disclosure of facts within their knowledge.[85]

Estate Agents

2.4.16 Estate Agents are obliged not to deal personally in a transaction (i.e the equivalent of dealing off their own book). The estate agent must utilise all the information available to him when acting for the customer and therefore cannot take a unilateral decision not to bring offers to the customer's attention or to discriminate between different offerors. The agent cannot act for both sides to a transaction, which means that problems occur where the estate agent provides financial services for the purchaser and takes a commission.

Accountants

2.4.17 An accountancy firm may carry out many different functions, the major activities being auditing, tax advice, insolvency work, and financial advice and consultancy. In their work accountants are subject to various statutory duties, for example the duty to verify the substantial accuracy of a company's balance sheet and to see that it contains a correct representation of the company's affairs, when performing an audit.[86] When carrying out auditing, tax advice, and insolvency work, accountants face few problems in complying with their fiduciary duties, the only applicable duty being to keep information which they obtain about their clients confidential except where they are subject to a contrary statutory obligation.[87] However, problems may arise where accountants also give financial advice, especially if this relates to investments. In the course of their other work accountants are likely to gain knowledge of confidential price sensitive information and, due to the attribution of knowledge within the firm, they may find themselves in breach of their duty to the financial advisory department's customer due to their failure to utilise all the information available. This will, of course, only occur where the financial advisory department is part of the same legal entity as the other departments. If the financial advisory department is part of a separate legal entity then attribution of knowledge from other departments will not occur.[88]

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[85] Horne, *Cordery's Law Relating to Solicitors* (8th ed., 1988) (hereafter "*Cordery*"), at 10-11.

2.5 Overview of the Regulatory Structures

(i) **Financial Services**

2.5.1 The FSA prohibits the carrying on of investment business in the United Kingdom by those who are neither statutorily authorised nor exempted.[89] The structure created by Part I of the Act for the regulation of investment business is a complex one. It placed the primary regulatory power in the Secretary of State for Trade and Industry[90] but envisaged that many, but not all,[91] of the statutory powers would be delegated to the SIB,[92] a company limited by guarantee, which would in turn recognise SROs with responsibility for specific areas of investment business.[93] The power to delegate was conditioned [94] on the Secretary of State being satisfied, inter alia, that the SIB's rules provided an adequate level of investor protection according to principles set out in the Act,[95] a satisfactory monitoring and enforcement system, and effective arrangements for dealing with investors' complaints.[96] The FSA was amended by the Companies Act 1989. We shall see that there are to be three tiers of rules: statements of principle, Core Rules, and third tier rules fleshing out the application of the Core Rules to particular situations. The first two tiers are made by the SIB, the third is made by the SROs. The Core Rules will apply to and bind members of SROs[97] as well as those directly regulated by the SIB.[98]

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[86] The auditor's report must state whether a "true and fair view" is given by the accounts - Companies Act 1985, s. 235(2), as inserted by Companies Act 1989. There is also a statutory requirement of independence for auditors - Companies Act 1989, s. 27, although the requirements of this are presently of a limited nature. It would appear that the provision of services, other than audit services, by an accountancy firm to its audit clients produces a conflict between the firms interest in retaining its customer and its duty to report on whether the accounts give a true and fair view. See paras. 4.2.3 and 2.5.28, n. 200, below, and DTI consultative document, *Regulation of Auditors - Implementation of the EC Eighth Company Law Directive*, paras. 2.24.6-2.24.7.

[87] The duty of confidence has been statutorily modified for auditors by FSA, s. 109.

[88] See Section 4.2, below for a comment on elimination of conflicts by separation of functions.

[89] FSA, s. 3.

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[90] Among the most important of the powers given to the Secretary of State are those to authorise individuals and recognise self-regulating organisations (Ch. III), to make conduct of investment business rules (Ch. V) including conduct of business, financial resources, client money and unsolicited calls rules, to intervene (Ch. VI) and (s. 49), and to publish information concerning authorised persons and recognised self-regulating organisations, to call for information and to investigate the affairs of any person carrying on or appearing to the Secretary of State to be or to have been carrying on any investment business (Ch. X).

[91] By s. 114(5) functions relating to *inter alia* the certification of persons authorised in another EC state (s. 31(4)), the scope of the category of exempted persons (s. 46) and exempted advertisements (s. 58(3)), may not be delegated.

[92] S. 114(2)

[93] Ss. 7-14. Ss. 15-21 enable members of professions who engage in investment business to be authorised by certification from a RPB. Investment exchanges and clearing houses which satisfy statutory requirements similar to those for the SIB and SROs are exempt from and do not require authorisation; FSA, ss. 36-37, Sch. 4 RIEs; ss. 38-39 RCHs.

[94] FSA, s. 114(1)(a).

[95] FSA, s. 114(9); Sch. 8. See paras, 2.5.3(iii), and 2.5.6, below.

[96] FSA s. 114(1)(b); Sch. 7. See para. 2.5.3(i) and (ii), below.

[97] They have bound members of IMRO since 30 November 1991 and members of SFA since 1 April 1992.

[98] FSA s. 63A (inserted by Companies Act 1989, s. 194) empowers the SIB to designate rules as applying to the members of SROs, and the Core Rules are so to apply, subject in some cases to any express exceptions in the third tier SRO rules.

2.5.2 Powers were delegated to the SIB in 1987, 1988, and 1991,[99] but the Secretary of State retains certain powers (some concurrently with the SIB)[100] and may resume the others if it appears to him that the requirements of the Act are not satisfied or that the SIB is unable or unwilling to discharge its functions.[101] The Secretary of State together with the Governor of the Bank of England appoint members of the SIB.[102] The Bank of England regulates deposit taking and lending[103] and its approval exempts bodies from the need for authorisation for certain money market activities.[104] The Secretary of State has powers to control any restriction, distortion, or prevention of competition, to a greater extent than is necessary to protect investors, by the rules of SROs.[105] The Secretary of State is also required to consult the Director General of Fair Trading on the effect on competition of regulatory rules[106] but SIB and SRO rules are otherwise exempt from the mainstream United Kingdom competition law. In respect of insurance, the DTI exercises prudential regulation and authorisation of insurance companies,[107] Lloyd's business is mainly run on a self-regulating basis under the Council of Lloyd's,[108] intermediaries describing themselves as brokers are regulated by the IBRC,[109] but the SIB and recognised SROs regulate the marketing of long term insurance business which falls within the FSA's definition of "investments".[110]

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[99] Financial Services Act 1986 (Delegation) Order 1987 S.I. 1987/942; Financial Services Act 1986 (Delegation) (No.2) Order 1988 S.I. 1988/738; Financial Services Act 1986 (Delegation) Order 1991 S.I. 1991/200; Financial Services Act 1986 (Delegation) (No. 2) Order 1991 S.I. 1991/1256.

[100] See Financial Services Act 1986 (Delegation) Order 1987 S.I. 1987/942 Schs. 1 and 2 and Financial Services Act 1986 (Delegation) (No.2) Order 1988 S.I. 1988/738, reg. 3 for powers not transferred or in respect of which the Secretary of State retains concurrent power with SIB. The most important of these powers are appointment to the SIB (FSA, Sch. 7, para. 1(2)); investigation under FSA s. 94; requiring SIB or SROs to change their rules if they are considered to be significantly anti-competitive (FSA ss. 120(4), 121(2)(3)) or incompatible with Community or international obligations (FSA s. 192 as substituted by Companies Act 1989, s. 201). The Secretary of State also has power to amend the definition of "investment" and "investment business" by subordinate legislation (FSA s. 2). See also s. 114(5) and n. 91 above for non-delegable powers.

[101] S. 115.

[102] Sch. 7, para.1(2).

[103] Banking Act 1987.

[104] FSA, s. 43.

[105] S. 119.

[106] S. 122.

[107] ICA, see para. 2.5.20, below.

[108] Lloyd's Acts 1871-1982, see paras. 2.5.16-2.5.18, below.

The Securities and Investments Board

2.5.3 The requirements for delegation of regulatory power to the SIB included that it has:

(i) a satisfactory system for monitoring and enforcing compliance with obligations which it is its responsibility to enforce,

(ii) effective arrangements for the investigation of complaints arising out of the conduct of investment business,[111] and

(iii) in respect of rulemaking power, that the SIB's rules afford investors an adequate level of protection and comply with the principles set out in Schedule 8.[112]

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[109] IB(R) Act, see paras. 2.5.21-2.5.23, below.

[110] FSA, Part II, Sch. 1, para. 10.

[111] Sch. 7, para. 4 SIB Conduct of Business Rules, r.35. For the position of SROs see Sch. 2, para. 6; SFA Conduct of Business Rules, r.35.

[112] For these see para. 2.5.6, below.

2.5.4 Section 62A of the FSA gives private investors[113] a right to civil damages for contravention of the SIB conduct of business rules (and indeed the rules of SROs). The SIB has also established a scheme to compensate investors for liabilities incurred by persons authorised to carry on investment business who are in default. Under the scheme the first £30,000 of a claim is to be met in full, and 90% of the next £20,000, subject to an overall maximum of £48,000 for claims which exceed £50,000.[114] However, the SIB is immune from liability in damages in respect of anything done or omitted in the discharge or purported discharge of its statutory functions unless it is in bad faith.[115]

2.5.5 Executive and enforcement powers These include the power to authorise individuals,[116] to recognise SROs and RPBs and to revoke such authorisation and recognition, to levy charges, to call for information, to investigate[117] and to seek injunctions and restitution orders. Decisions of the SIB to refuse to grant authorisation, to withdraw or suspend authorisation, to disqualify a person from employment in an investment business, and to issue a public statement about an authorised person's misconduct or concerning prohibition notices may be referred to the Financial Services Tribunal by those in receipt of notices by the SIB.[118] The Tribunal reports to the SIB stating what would in its opinion be the appropriate decision in the matter and it is the duty of the SIB to decide the matter in accordance with this report.[119]

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[113] Inserted by Companies Act 1989, s. 193(1). For the definition of "private investor" for this purpose, see Financial Services Act 1986 (Restriction of Right of Action) Regulations 1991 S.I. 1991/489. For the SIB's definition of "private customer", which differs, see the Financial Services Glossary (2nd. ed), 1991 (set out in Appendix 3) and Blair, *Financial Services: The New Core Rules* (1991), at 44-46. See also Lomnicka and Powell, *Encyclopedia of Financial Services Law* (1987), at 4-215, 5-18/21; Lomnicka, "Curtailing Section 62 Actionability", [1991] 1 J.B.L. 353. The definition for the purposes of s. 62A is narrower than the SIB's, which includes certain small business investors. A s. 62 action may, in limited circumstances, be available to a person other than a private investor; see S.I. 1991/489, reg. 3 and Lomnicka and Powell, *op. cit.*, at 4-216.

[114] Financial Services (Compensation of Investors) Rules 1990 rule 2.07. On the operation of the scheme, see *SIB* v. *FIMBRA* [1991] 3 W.L.R. 889.

[115] FSA, s. 187(3).

[116] But see SIB Retail Regulation Review, *Report of a Study by Sir Kenneth Clucas on a new SRO for the Retail Sector* (March 1992), at 43 where Sir Kenneth suggests that if an opportunity for legislation should occur it should be considered whether direct regulation of firms by the SIB should cease.

[117] These are backed up by sanctions.

[118] FSA, ss. 96-97. See further para. 5.3.1, below.

2.5.6 Rulemaking powers These include power to make rules for the conduct of business including the handling of transactions, unsolicited calls, customer's money, and advertising and the compensation of investors. A primary aim of the rules is to provide an adequate level of investor protection[120] and to that end the rules must satisfy the detailed principles set out in the FSA. These include requirements that the rules must promote high standards of integrity and fair dealing in the conduct of investment business[121] and make proper provision for requiring an authorised person to:

(i) act with due skill, care and diligence,[122]

(ii) subordinate his own interests to those of his customers and to act fairly between clients,[123] and

(iii) disclose interests in, and facts material to, transactions entered into or advice given, and the capacity in which and the terms on which he enters into any transaction.[124]

The Secretary of State's rulemaking power under the FSA was not subject to these principles and, in this respect, the SIB's rulemaking power is more constrained than the Secretary of State's would have been had he not transferred the power to it. The SIB's rulemaking power is also subject to the control of the Secretary of State who, if it appears to him that the SIB's rules do not afford investors an adequate level of protection, may revoke a delegation order in whole or in part.[125]

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[119] FSA, s. 98(1).

[120] FSA, ss. 114(9); 115(2).

[121] FSA, Sch. 8, para. 1.

[122] FSA, Sch. 8, para. 2.

[123] FSA, Sch. 8, para. 3. Cf. SIB Principle 6, which states that a firm should not *unfairly* place its interests above those of its customers, which suggests that it is not always impermissible to place the firm's interests above those of the customer.

[124] FSA, Sch. 8, paras. 5 and 6.

2.5.7 The Companies Act 1989 amended the FSA in a number of ways. First, it empowered the Secretary of State, i.e. after delegation to the SIB,[126] to designate provisions in its rules as applying to the member of a recognised SRO to the extent specified in respect of investment business in the carrying on of which he is subject to the rules of the organisation.[127] This in substance replaces the less direct power, now only available in limited circumstances,[128] to require SROs to change their rules. Secondly, it created a power in the Secretary of State, i.e. after delegation the SIB, to issue statements of principle.[129] Failure to comply with a statement of principle is a ground for disciplinary action, including the exercise of powers of intervention and applications for injunctions and restitution orders, but does not of itself give rise to any right of action by investors or third parties or affect the validity of a transaction. The 1989 Act also provides for codes of practice with respect to matters dealt with by statements of principle or rules. Failure to comply with a code of practice may be relied upon as tending to establish failure to comply with the statement of principle or rule and compliance may be relied upon as tending to negative such failure.[130] As yet no such codes of practice have been issued.

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[125] FSA, s. 115(5). The SIB must submit a copy of the rules to the Secretary of State: Sch. 9, para. 4(1).

[126] Companies Act 1989, s. 206(2); S.I. 1990/354, reg. 3.

[127] FSA, s. 63A inserted by Companies Act 1989, s. 194. The Core Rules are so to apply subject, in some cases, to any express exceptions in the third tier SRO rules: Blair, *Financial Services: The New Core Rules* (1991), at 45-46. The Core Rule cannot, however, apply to those authorised by certification by a RPB and we shall see that this may have important practical consequences.

[128] FSA, s. 13; Sch. 3 para. 3(1) as amended by Companies Act 1989, s. 203.

[129] FSA, s. 47A inserted by s. 192 of the Companies Act 1989.

[130] FSA, s. 63C, inserted by Companies Act 1989, s. 195. Contravention of a code of practice concerning a matter dealt with by rules does not of itself give rise to any liability or invalidate any transaction: FSA, s. 63C(3).

2.5.8 There are thus three types of legislative function exercised by the SIB: statements of principle, rulemaking and codes of practice with respect to matters dealt with by either of the first two. Valid rules made by the SIB have statutory force and the same effect as if they were in the statute.[131] Principles and codes of practice do not have statutory force but have a more limited legislative effect.[132]

2.5.9 The first SIB and SRO rule books were considered to be over-elaborate and the present rules reflect a policy, embodied in the 1989 amendments to the FSA,[133] to replace the complexity and diversity of the rule books taken as a whole by a simple common core of obligations. The aim was to focus attention on conformity to the underlying purpose of the rules rather than whether there had been technical compliance with their letter. The new approach does not affect the extent of the SIB's rulemaking powers but it may affect the court's view of what the relationship between the rules actually made and the general law is in practice.

2.5.10 The SIB's rulemaking powers in Part I of the FSA can conveniently be considered under the following broad categories:[134]

(i) the qualifications of authorised persons,[135]

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[131] Bennion, *Statutory Interpretation* (1984), at 133-134.

[132] See in general Ganz, *Quasi-Legislation: Recent Developments in Secondary Legislation* (1987), Ch. 2. See also Ferguson, "The Legal Status of Non-Statutory Codes of Practice", [1988] J.B.L. 12.

[133] SIB, "Regulation of the Conduct of Investment Business: A Proposal" (1989) at 1, 3, 6; SIB "A Forward Look" (1989), Ch. 4, paras. 6.7-6.12.

[134] This is a categorisation of convenience rather than logic.

[135] Financial resources requirements (FSA, s. 49); the information required from applicants for authorisation to enable the determination of whether they are "fit and proper" persons (FSA, s. 26(2)).

(ii) the duties of directly authorised persons and of recognised SROs to the SIB,[136]

(iii) matters affecting relations between authorised persons and those doing or who may do business with them,[137]

(iv) the rules of SROs,[138] and

(v) compensation and indemnity of those doing business with authorised persons.[139]

Categories (i) and (ii) do not affect the rights and duties of authorised persons[140] and those doing business with them and (iv) and (v) only do so indirectly. In the present context we shall therefore be primarily concerned with the precise effect of rulemaking powers and rules in category (iii) on the rights and duties of authorised persons and those doing business with them. These will be discussed in Part V of this paper.

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[136] Notification requirements by SROs, RPBs, RIEs and RCHs and directly authorised persons (FSA, ss. 14, 21, 41, 52); appointment of auditors (FSA, s. 107).

[137] The conduct of business (FSA, s. 48); cancellation (FSA, s. 51); client's money (FSA, s. 55); unsolicited calls (FSA, s. 56); constitution and management of unit trust schemes (FSA, s. 81); publication of unit trust scheme particulars (FSA, s. 85).

[138] Alteration of SRO rules (FSA, s. 13(1)).

[139] Compensation where authorised person unable to satisfy claims (FSA, s. 54). Note that the power to make rules concerning indemnity in respect of liability by an authorised person (FSA, s. 53) has not been delegated to the SIB (S.I. 1987/942, Sch. 1, para. 5) and no rules under s. 53 have yet been made by the Secretary of State.

[140] In relation to directly authorised persons, category (b) may have an indirect effect since breach of these rules will ground a section 62 action for damages.

Self-Regulating Organisations

2.5.11 The SROs are an integral part of the FSA's scheme of regulation as it has developed. At the present time[141] there are four: the SFA,[142] IMRO, LAUTRO and, FIMBRA. These are respectively responsible for dealing in domestic and international securities, money market instruments, options, swaps, futures and contracts for differences (SFA), management of investment portfolios and collective investment schemes (IMRO), life assurance and pooled investments businesses, excluding independent intermediaries (LAUTRO), and independent investment intermediaries serving the retail market (FIMBRA).

2.5.12 SROs are not expressly given rulemaking powers by the FSA, perhaps because it was assumed that the self-regulatory systems would operate contractually. However, the content of a SRO's rules must satisfy the requirements of Schedule 2 of the FSA if it is to be recognised under the statute.[143] If the rules cease to meet these requirements the SIB may either revoke recognition, seek a compliance order under section 12, designate provisions in its own rules as applying to members of the SRO,[144] or, under section 13,[145] itself alter the SRO's rules in order to protect investors. The effect is that a SRO's freedom to draw up its own constitution and to contract with its members on such terms as may be mutually agreed is significantly restricted in order to advance the statutory aim of protecting investors.

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[141] But see SIB Retail Regulation Review, *Report of a Study by Sir Kenneth Clucas on a new SRO for the Retail Sector* (March 1992), in which Sir Kenneth recommends that a new SRO should be created to regulate investment business done with or for the private investor and that FIMBRA and LAUTRO should cease to exist, leaving three SROs instead of four. Sir David Walker, the Chairman of the SIB said that the case for a new SRO, to reduce fragmentation and improve the robustness of the regulatory structure, is compellingly made out and that the SIB aims to work within the timetable envisaged by Sir Kenneth, with a new SRO to be in place by April 1993, (SIB Press Release, "SIB Publishes Clucas Report", 17 March 1992).

[142] Formed by a merger of the Securities Association ("TSA") and the Association of Futures Brokers and Dealers ("AFBD") in 1991.

[143] FSA, s. 10.

[144] FSA, s. 63A (inserted by Companies Act 1989, s. 194). (The designation power is a general power and is not dependent on failure of SRO rules to meet the requirements of Sch. 2).

[145] Originally there was a general power under s. 13(1) but this was removed by the Companies Act 1989, Sch. 23, para. 1 and there is now only power to alter rules, where a SRO is concerned with two or more kinds of investment business and the requirements of para. 3(1) of Sch. 2 are not met in respect of one but not both kinds of business. However, in view of the SIB's power under FSA, s. 63A there is no real loss of control.

2.5.13 Schedule 2 requires that a SRO's rules must:-

(i) afford "an adequate level of protection for investors",[146]

(ii) secure that its members are fit and proper persons to carry on the relevant class of investment business,

(iii) have similar arrangements for intervention to the SIB,

(iv) have adequate arrangements for monitoring and enforcing compliance with its rules, and

(v) have effective arrangements for the investigation of complaints.

Furthermore, SRO rules relating to admission, expulsion and disciplinary powers must be fair and reasonable and include provision for appeals. In determining whether the requirements of Schedule 2 are satisfied the entirety of the regulatory scheme must be considered.[147]

(ii) **Legal Services**

Solicitors

2.5.14 The Law Society has extensive executive[148] and rulemaking[149] powers concerning professional practice, conduct and discipline. Although most statutory disciplinary functions are vested in the Solicitors' Disciplinary Tribunal,[150] the Law Society retains some statutory and inherent powers relating to discipline, which it has delegated to the Adjudication Committee of the Solicitors Complaints Bureau,[151] including power to impose sanctions for inadequate professional services[152] and powers of intervention in solicitors' practices.[153] A Legal Services Ombudsman has been established.[154] He may investigate allegations relating to the manner in which a complaint about a solicitor has been handled by the Law Society, and the matter to which the complaint relates.[155] Appeals in relation to practising certificates may be made to the Master of Rolls, (or the High Court in relation to a refusal to issue a certificate).[156]

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[146] FSA, Sch. 2, para. 3(1) as amended by the Companies Act 1989, s. 203(1). Prior to that the requirement was that the level of investor protection be "at least equivalent" to that in the SIB rules.

[147] FSA, s. 128A; Sch. 3, para. 2 (as amended by Companies Act 1989, ss. 196 and 203).

[148] See generally *Cordery*, at 288-311.

Barristers

2.5.15 Since 1987 the self-regulating body responsible for the governance of the barristers' profession has been the Bar Council[157] which now operates within the framework of the Courts and Legal Services Act 1990.[158] The current code of conduct which regulates

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[149] Solicitors Act 1974, ss. 2, 31, 32, 28, 37.

[150] Solicitors Act 1974, s. 46. See also *Cordery*, at 288.

[151] Set up by the Law Society under Solicitors Act 1974, s.79. See generally The Law Society's General Regulations 1987, reg. 34; *The Guide to the Professional Conduct of Solicitors* (1990), at 167-169.

[152] Solicitors Act 1974, s. 44A (added by the Administration of Justice Act 1985, s. 1).

[153] Solicitors Act 1974, s.35 and Sch.1.

[154] Courts and Legal Services Act, 1990, s. 21.

[155] Courts and Legal Services Act 1990, s. 22.

[156] Solicitors Act 1974, ss.13, 13A, 16.

[157] See Halsbury's *Laws of England* (4th ed.) vol.3(1), paras.360-362, 367-370.

[158] The regulations and rules of conduct in force on 7 December 1989 were deemed to be properly approved (s. 31). Future changes to the advocacy rules will be subject to approval by the Advisory Committee (s. 29) and see also ss. 58, 61 and 66 on conditional fees, contracts and partnerships.

professional practice was adopted by the Bar Council in January 1990.[159] The code covers barristers in independent practice, employed barristers and non-practising barristers. As barristers in independent practice are required to be sole practitioners and may not enter into partnership there is little scope for conflict between the duties owed to their lay and professional customers under the general law and those owed under the code of conduct. A barrister must not accept instructions "if there is or appears to be some conflict or a significant risk of some conflict either between the interests of the barrister and some other person or between the interests of any one or more of his clients".[160] Disciplinary functions are vested in the Bar Council which has set up a professional conduct committee, a disciplinary tribunal and a summary tribunal.[161] The Legal Services Ombudsman[162] has power to investigate allegations concerning the way in which a complaint made to the Bar Council has been dealt with by it and the matter to which the complaint relates. Barristers are immune from suit in negligence in respect of their conduct of a case in court and closely related matters.[163]

(iii) **Insurance Services**

Lloyd's

2.5.16 The regulatory structure of Lloyd's has resulted primarily from a succession of private statutes, the Lloyd's Acts 1871 to 1982.[164] Lloyd's has enjoyed appreciable exemptions from general British insurance legislation,[165] although in recent years European Community directives have necessitated some formal encroachment.[166] Prior to the 1982 Act the market was self-regulated, with regulations and byelaws being made by a general meeting of the members of the Society. The Committee was given little more than an executive function. It had no legislative powers and its disciplinary authority was restricted to the ability to suspend a member for up to two years if a five-sixths majority of the committee found that he was guilty of discreditable behaviour. Although the Committee had tried to strengthen its regulatory role by using "undertakings" and "conditions", these new rules tended to apply only to new entrants with the result that various generations of members, brokers, and managing agents were subject to different sets of requirements. The matter of regulation come to a head following several reviews of the Society,[167] and a series of scandals in the late 1970s and early 1980s.

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[159] Since then 2 amendments have been made.

[160] The Code of Conduct of the Bar of England and Wales, para. 501. This is an exception to the "cab-rank rule" which obliges barristers to accept instructions irrespective of the identity of the lay client or the nature of the case.

[161] The rules of the professional conduct committee and disciplinary tribunal are set out in annexes to the code of conduct.

[162] See para. 2.5.14, and n. 155, above.

[163] *Rondel* v. *Worsley* [1967] 1 A.C. 191; *Saif Ali* v. *Mitchell (Sydney) and Co. (a firm)* [1980] A.C. 198.

[164] Acts were enacted in 1871, 1911 1925, 1951 and 1982.

2.5.17 The Lloyd's Act 1982 introduced a new regulatory framework in line with the recommendations of the Fisher Working Party. A Council of both working and non-working members of the Society was formed. The Council was given power to make regulations and bye-laws which would take effect subject to veto by a qualified majority at a general meeting of the Society. One of the most important changes introduced by the Act, despite opposition of many members of Lloyd's, was a prohibition on brokers holding an interest in underwriting agencies. This practice had clearly led to some conflicts of a fiduciary nature since the brokers placing business for their customers had an interest in the underwriting agency with which they did business. It demonstrates the problems of self-interest that may arise in an entirely self-regulated market.[168]

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165. For example, ICA, s. 15(4).

166. For example, ICA, ss. 83-86.

167. Lord Cromer was asked by the Committee of Lloyd's to prepare a report on "what should be done to encourage and maintain an efficient and profitable Lloyd's". The report was delivered to the Committee at the end of 1969 and, although some of its recommendations were implemented, it was given only a limited circulation; Sir Henry Fisher was asked by the Committee to review the regulatory structure of the market, the Fisher Working Party Report being delivered in 1980.

168. See also paras. 3.2.16-3.2.17, below.

2.5.18 The exclusion of Lloyd's from the ambit of the FSA was strenuously opposed by members from both sides of the House during its passage through Parliament. In response, the Government asked Sir Patrick Neill Q.C. to report whether the arrangements at Lloyd's provided protection comparable to that proposed by the FSA. The report concluded that the protection was inadequate when compared with that given by the FSA, and made recommendations which were implemented by the Council. The latest report on Lloyd's by a taskforce chaired by Mr David Rowland at the request of the Committee,[169] contains recommendations for further changes to the structure of the Society. In the present context those concerning the relationship of members and underwriting agencies and of brokers and underwriting agents are of particular relevance. On the first relationship, the taskforce recommended that combined agents should not be required to dispose of their interests in members' agencies but that there should be a greater separation of functions and independence of decision-making within combined agents and tighter market disciplines on agent remuneration, including more openly negotiated fees and greater disclosure.[170] As far as the second relationship, between brokers and underwriting agencies, is concerned, the taskforce recommended that the market should seek to reverse the divestment provisions of the Lloyd's Act 1982 "in order to give Lloyd's managing agents and brokers the strategic flexibility to respond to future changes in the insurance industry and provide clients with the service they see". [171] The taskforce considered the ownership restriction imposed by the Lloyd's Act 1982 as an unnecessary restriction on Lloyd's commercial freedom, and commented that its implementation contrasted strangely with the opposite development in the Stock Exchange where dual capacity was permitted in the interests of international competitiveness. The taskforce believe that the regulatory regime at Lloyd's is now strong enough to provide assurance in the area that led to the imposition of divestment.[172]

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[169] "Lloyd's: a route forward - Report of the Task Force" (1992).

[170] *Ibid.*, paras.8.4, 4.21-24, 8.39, 8.40-46.

[171] *Ibid.*, paras.13.3, 13.59.

[172] *Ibid.*, para.13.57.

Insurance Companies

2.5.19 In the insurance market there are two different types of insurance product, and this is reflected in the regulatory structure. The two products are "long term business" defined in Section 1(1) and specified in Schedule 1 of the ICA, and "general business" defined in Section 1(1) and specified in Part I of Schedule 2 of the ICA. Most kinds of long term business are defined as an investment for the purpose of the FSA[173] and thus firms dealing in this type of insurance (this includes the sale of insurance) are subject to the regulatory structure imposed by the FSA for persons dealing in investments.

2.5.20 Subject to certain exceptions[174] any person carrying on insurance business in the United Kingdom must be authorised under section 3 or 4 of the ICA. If a company is so authorised it is also authorised under section 22 of the FSA to carry on any of its insurance business which is investment business, and any other investment business which it may carry on without contravening section 16 of the ICA. Regulation of insurance companies is provided for by Part II of the ICA, and by the FSA.

Insurance Brokers

2.5.21 The sale of insurance is carried out by a range of people and bodies which include tied agents, independent financial advisers, insurance brokers, solicitors, and accountants, as well as insurance companies themselves. Insurance which constitutes long term business within the meaning of the ICA is an investment as defined in Schedule 1 Part I of the FSA, and as such may only sold by a person authorised, or exempted in accordance with the FSA.[175] Thus any person selling long term insurance must be authorised either by the SIB, a SRO, a RPB, or be an appointed representative of an authorised firm. The sale of insurance is also regulated by the IB(R) Act which provides that the term "insurance broker" or related terms may only be used by persons registered with the IBRC.

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[173] FSA, Sch. 1.

[174] ICA, s.2.

[175] FSA, s.3.

2.5.22 A series of Statutory Instruments made under the IB(R) Act lay down detailed requirements for the carrying on of business by insurance brokers, including a Code of Conduct designed to regulate the professional standards of insurance brokers. The investment business activity of insurance brokers may also be regulated by the IBRC in its role as a RPB under the FSA.[176] There are, however, strict rules as to the proportion of investment business that may be carried on by an insurance broker regulated by the IBRC - currently up to 49% of turnover may be from investment business (apart from insurance business). Thus insurance brokers often register with FIMBRA as well as with the IBRC which enables them to conduct their investment business under the FIMBRA rules and thus avoid the turnover restrictions imposed by the IBRC.

2.5.23 Insurance brokers broking insurance business at Lloyd's must be registered with the IBRC under the IB(R) Act. They are additionally required to be registered as Lloyd's brokers under the Lloyd's Brokers byelaw (No.5 of 1988). The Byelaw empowers the Council of Lloyd's to impose conditions and make requirements for the granting of registration and there is a Code of Practice for Lloyd's brokers.[177]

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[176] Sir Kenneth Clucas suggests that if legislation is contemplated in the future, recognition should be withdrawn from the IBRC as its presence in the FSA framework is an anomaly: SIB Retail Regulation Review, *Report of a Study by Sir Kenneth Clucas on a new SRO for the Retail Sector* (March 1992), at 44-5.

[177] On Lloyd's brokers, see further paras. 1.9, above and 3.2.16-3.2.17, below.

(iv) **Property Services**

Estate Agents

2.5.24 The major source of regulation of estate agency work is provided by the Estate Agents Act 1979.[178] The Act applies to all persons carrying out estate agency work in the course of a business[179] unless they fall within the exceptions provided by the Act.[180] The Act gives the Secretary of State the power to make regulations specifying minimum standards of competence required by those engaged in estate agency work,[181] but at present no such regulations have been made. The Act also makes provision for the handling of customers' money by estate agents.[182]

2.5.25 However, the chief regulatory role in this area is assigned by sections 3 and 4 of the Act to the Director General of Fair Trading. Under section 3 of the Act the Director General may make an order prohibiting a person from carrying on estate agency work generally or of a particular description.[183] Before he makes such an order the Director must be satisfied that the person against whom he is making it is unfit to carry on estate agency work generally, or of a particular description,[184] and that that person has either been convicted of an offence listed in section 3(1)(a) of the Act, discriminated in the course of his estate agency work,[185] failed to comply with any of the obligations imposed under the Act,[186] or has engaged in a practice which has been declared undesirable by an order made by the Secretary of State in accordance with his powers under the Act.[187] Section 4 of the Act provides that the Director may make a warning order against a person engaged in estate agency work if he is satisfied that the person has failed to comply with any of the obligations imposed by the Act, or has engaged in an undesirable practice.[188] The Director must also be satisfied that were the person to fail to comply with the obligations, or continue to engage in undesirable practices in the future, then the Director would consider him unfit in accordance with section 3.[189] If a person who has had a warning order made against him fails to comply with an obligation under the Act or engages in an undesirable practice, that fact may be treated as conclusive evidence that he is unfit in accordance with section 3 of the Act.[190]

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[178] There is no industry-wide self-regulatory body for Estate Agents. Estate Agents who are members of professional bodies, such as the Royal Institution of Chartered Surveyors, and the Incorporated Society of Valuers and Auctioneers will be subject to regulation by those bodies. In its March 1990 report on Estate Agency the Office of Fair Trading recommended the introduction of an industry-wide voluntary code of practice (para.6.5(o)), but it held out little hope of such a code being established (para.5). See also the Property Misdescriptions Act 1991 which provides for an offence of misdescribing property, the offence to be confined to matters prescribed by an order made by the Secretary of State. At the present time the Secretary of State has made no such order.

[179] Estate agency work is defined by Estate Agents Act 1979, s.1(1).

[180] Estate Agents Act 1979 ss.1(2)-1(4).

[181] *Ibid.*, s.22.

[182] *Ibid.*, ss.12-17.

[183] *Ibid.* s.4(3).

[184] *Ibid.*

Licensed Conveyancers

2.5.26 The Administration of Justice Act 1985 introduced a regulatory framework enabling licensed conveyancers to undertake conveyancing work for reward.[191] The new system followed, in many respects, the recommendations made by the first report of the Conveyancing Committee.[192] The Act provided for the establishment of the Council for Licensed

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[185] *Ibid.*, s. 3(1)(b). Provisions as to 'spent' convictions, and the meaning of discrimination are contained in Sch. 1 of the Act.

[186] *Ibid.*, s. 3(1)(c). The relevant obligations are contained in ss. 15, 18 and 21 of the Act, and S.I. 1991/859 made by the Secretary of State in exercise of the powers conferred on him by s. 18(4) of the Act.

[187] *Ibid.*, s. 3(1)(d). S.I. 1991/1032 was made by the Secretary of State in exercise of this power.

[188] *Ibid.*, s. 4(1)(a).

[189] *Ibid.*, s. 4(1)(b).

[190] *Ibid.*, s. 4(3).

[191] Administration of Justice Act 1985, ss. 11-39, Schs. 3-6.

[192] Presented to the Lord Chancellor in September 1984.

Conveyancers[193] to ensure that the standards of competence and professional conduct of licensed conveyancers are sufficient to ensure adequate consumer protection. In order to comply with this duty the Council is required to make rules regulating the professional practice, conduct and discipline of licensed conveyancers.[194]

Authorised Conveyancers

2.5.27 The Courts and Legal Services Act 1990 provides for the extension of conveyancing services[195] so that banks, building societies, insurance companies, and other organisations and individuals who meet the requirements[196] of the Act will be able to offer such services to the public. The Act establishes the Authorised Conveyancing Practitioners Board[197] which has a duty to develop competition in conveyancing services and to supervise the conveyancing services provided by authorised practitioners.[198] The Act gives the Lord Chancellor the power to make provisions by regulation with a view to securing competence, fair competition, and protection of customers' interests.[199] Section 40(2)(a) of the Act provides that such regulation may make provision designed to avoid conflict of interests.

(v) **Accountancy Services**

2.5.28 There are several self-regulatory bodies for accountants. The two most significant in England are the ICAEW and the CACA. Accountants may need to be authorised for several aspects of their practices. Advising and arranging deals in investments requires authorisation under the FSA. Acting as a company auditor requires authorisation in accordance with Part II of the Companies Act 1989. Acting as an insolvency practitioner requires authorisation in accordance with Part XIII of the Insolvency Act 1986. The ICAEW and the CACA are RPBs under both the FSA and the Insolvency Act 1986. Thus they may authorise their members to carry out the appropriate business, and they are both RSBs under the Companies Act 1989.[200] Accountants who are members of these self-regulatory bodies are subject to the rules of practice which are enforced by them but are also subject to the statutory rules that are in force relating especially to auditing and insolvency work. Thus in the areas covered by the above statutes accountants are subject to both statutory and self-regulatory requirements, practices outside these areas being subject only to voluntary self-regulation.

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[193] Administration of Justice Act 1985 s. 12 and Sch. 3.

[194] *Ibid.*, s. 20.

[195] Courts and Legal Services Act 1990, ss. 34-52 and Schs. 5-7. The introduction of the scheme has been postponed; see para. 5.3.40, below.

[196] Courts and Legal Services Act 1990, s. 37.

[197] *Ibid.* s. 34.

[198] *Ibid.*, s. 35.

[199] *Ibid.*, s. 40(1). But see para. 5.3.40, below.

2.6 European Community Legislation

2.6.1 European legislation also has a bearing on the legal framework for the regulation of the financial markets. Two Articles of the Treaty are particularly relevant with respect to the competence of the EC to legislate in this area. First, under Article 54(3)(g) the Community can enact Directives for the abolition of restrictions on freedom of establishment by making equivalent the safeguards for the protection of members and others who deal with companies and firms.[201] More importantly, since the Single European Act 1986, the Community can adopt measures (mainly by qualified majority) for the approximation of laws and regulations in Member States which have as their object the establishment and functioning

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200. Requirements for recognition of an RSB are set out in Companies Act 1989, Sch. 11, Part II. Para. 7 of this Part requires that a body must have adequate rules designed to ensure that persons are not appointed company auditor in circumstances in which they have any interest likely to conflict with the proper conduct of the audit if it is to be recognised.

201. Article 58(2) sets out the definition of "firms and companies". For a collection of relevant Directives enacted by the Community see Prentice, *EEC Directives on Company Law and Financial Markets*, (OUP, 1991).

of the internal market.[202] The EC legislation on financial markets involves two issues of importance to this Consultation Paper: (i) the substantive content of the legislation and (ii) the juridical effect of the legislation. The first of these is dealt with in paragraphs 4.6.1-4.6.2 and the latter in paragraphs 5.2.8-5.2.9.

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[202] The Insider Dealing Directive was adopted under Article 100A: see para. 4.6.1, below.

PART III

CONTRACTUAL TECHNIQUES FOR MANAGING CONFLICTS

3.1 Introduction

3.1.1 We have already considered the extent of the obligations imposed on different types of fiduciary by the general law and the structure of the modern financial conglomerate (hereinafter referred to as the firm) in Part II. One of the firm's salient features, as we have already seen, is that it acts in a number of differing capacities. As a consequence it is inevitable that conflicts of interest and conflicts of duty will arise. The nature of these conflicts has been described in Parts I and II.[1] Fiduciaries may attempt to resolve the conflicts of interest and duty, conflicts between two duties prescribed by these obligations, or between fiduciary obligations and the requirements of the regulatory scheme to which the fiduciaries are subject by a variety of "self-help" methods. These methods fall into two categories. First, there are what are referred to as contractual techniques. These solutions are arrived at by agreement of the parties[2] and include the use of clauses purporting to modify or exclude particular duties, making advance disclosure of particular activities which would otherwise amount to breaches of duty, and the development of trade practices which become implied terms of the contract. Secondly, there are structural techniques whereby the business of the firm is organised in such a way as to eliminate or minimise conflicts either by isolating sensitive information and controlling its flow through the use of Chinese walls, or by independence policies. These are considered in Part IV.

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[1] Paras. 1.13, 2.4.12-2.4.17, above.

[2] Although we refer to contractual solutions it may be that there are agreements designed to deal with the problem which do not have full contractual effect. Disclosure may also not have full contractual effect.

3.1.2 We have noted that many of the respondents to the Issues Questionnaire consider that the use of such techniques avoids any problems which might otherwise arise from differences between their duties under the general law and those imposed on them by the regulatory rules. In this Part and Part IV we examine the different techniques, consider their limitations, and assess any impact which the regulatory rules may have on them. It should, however, be noted that these techniques are not necessarily alternatives but in many ways are complementary since, as we shall see, the structural techniques also rely for their effectiveness on the extent to which contractual arrangements are in turn effective to deal with the problems of conflict. A further complication which we think is important is that the nature of a particular fiduciary relationship may evolve over time as where, for example, a firm which initially deals on an execution only basis, later gives the customer advice perhaps on an occasional and informal basis, thus giving rise to fiduciary duties.[3] It is for consideration whether contractual provisions, disclosure, and structural arrangements which may be adequate for the original relationship are in fact adequate for the relationship which has in fact evolved. A backdrop to these techniques for regulating conflict is the role of competition in providing protection to customers and accordingly it is necessary to evaluate the extent to which competition operates to protect the interests of customers.

3.1.3 The point was made frequently in the replies to the Issues Questionnaire that competition would prevent a firm from pursuing practices which are inimical to the interests of its customers. For example, if a firm was seen as failing to provide a customer with similar opportunities to participate in new issues which it was underwriting to those accorded to other customers, the disadvantaged customer would take his business elsewhere. However, while competition does have a significant regulatory impact and can operate to protect the interests of customers, it is not sufficient in itself. First, for competition to have the beneficent effect claimed for it, a customer must know what is happening. Customers, particularly private customers, will often simply not possess the information necessary to enable them to evaluate the quality of the service that they receive. For example, concern has been expressed about the adequacy of disclosure of commission and the "bundling" of charges for services which may mislead customers.[4] Again, in the underwriting example given above, a customer will need to know what new issues the firm has underwritten, who has been given an opportunity to participate, and the relative riskiness of the various new issues in order to evaluate the fairness of his own treatment. This information will not be known to many of the firm's customers, and, as regards those customers who do possess it, most firms would be astute enough not to do anything which would lead them to go to a competitor. Thus the informed would be advantaged at the expense of the ill-informed unless the regulatory system prevented this from occurring. Secondly, competition often operates after the event and it is of little solace to a customer to be informed that he can protect himself against future mistreatment by changing firms but has no remedy for past mistreatment.

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[3] See further para. 3.3.22, below.

3.2 Trade Customs and Rules of Practice

3.2.1 A firm whilst acting in accordance with a prevailing trade custom or rule of practice may act in a way which would normally be considered to breach either its common law or equitable duties to its customer. However, the trade custom or rule of practice may, in certain circumstances, modify those duties. In this section we assess the requirements which a course of conduct must satisfy in order to constitute a trade custom, and consider whether or not a trade custom may vary the fiduciary obligations inherent in a relationship.

Trade Customs

3.2.2 Trade customs (sometimes referred to as trade usages) may be deemed to be incorporated in the terms of any contract,[5] whether or not it is in writing,[6] unless the custom is inconsistent with the express or necessarily implied terms of that contract.[7] If a custom is to be incorporated then:

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[4] Council for The Securities Industry 1984/85 Report, para. 14; OFT Report, *The Disclosure of Information about Life Insurance Products and Commissions paid to Independent Financial Advisers* (1990), at paras. 2.13, 4.11.

[5] *Clark* v. *Smallfield* (1861) 4 L.T. 405, *per* Cockburn C.J.

> "it must be strictly proved. It must be so notorious that everybody in the trade enters into a contract with that usage as an implied term. It must be uniform as well as reasonable, and it must have quite as much certainty as the written contract itself."[8]

3.2.3 We shall first consider the factual criteria which a custom must fulfil in order for it to become an implied term in a contract.[9] These are, firstly, that there is a course of conduct, secondly, that the course of conduct is certain and uniform, thirdly, that it is notorious, and, lastly, that it is considered to be of a legally binding nature. These are all questions of fact. In order to clarify the differences between customs which fulfil the factual criteria and those that do not, we shall use the term "custom" only to identify a course of conduct that fulfils the factual criteria. Where the factual criteria are not fulfilled we will refer merely to "courses of conduct". The reasonableness of a custom, being a question of law, is a separate issue from the fulfilment of these factual requirements. However, evidence of the unreasonableness of a course of conduct may be used to show that any of the factual criteria have not been fulfilled.[10] For example, the evident unreasonableness of a course of conduct may be used to support an argument that the course of conduct could not have been generally accepted or known. It is clear that the existence of unreasonable customs is recognised by the courts.[11] We shall consider the factual criteria in three parts, firstly,

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[6] *Gibson* v. *Small* (1853) 4 H.L. Cas. 333, 397, *per* Parke B.; *Wilkins* v. *Wood* (1848) 17 L.J.Q.B. 319, 320, *per* Lord Denman C.J.; *Smith* v. *Wilson* (1832) 3 B. & Ad. 728.

[7] *Wilkins* v. *Wood, ibid.*, 320, *per* Lord Denman C.J.; *Moult* v. *Halliday* [1898] 1 Q.B. 125, 129, *per* Channell J.

[8] *Nelson* v. *Dahl* (1879) 12 Ch. 568, 575, *per* Jessel M.R.

[9] The reasonableness of a custom is a question of law: see paras. 3.2.13-3.2.22, below.

[10] *Bottomley* v. *Forbes* (1838) 5 Bing. (N.C.) 121, 128 *per* Tindal C.J.

[11] For example, in *Robinson* v. *Mollett* (1875) L.R. 7 H.L. 802, the existence of a custom permitting a tallow broker to deal off his own book was accepted, but it was held to be incompatible with the broker's position as an agent.

uniformity and certainty, secondly, notoriety, and finally, the requirement that there must be an intention that a course of conduct should have a binding effect.

3.2.4 The most common area in which courses of conduct have been held to constitute customs is that of traders and brokers practising in particular markets. It is with these situations that we are chiefly concerned. However, a course of conduct observed by a particular class of people may give rise to a custom,[12] as may a course of conduct within a particular industry or service.[13] Whether a course of conduct fulfils the uniformity requirement will depend upon the way in which the relevant market is defined. In general, the courts have accepted narrow definitions of the relevant market even though there may be similar wider markets in existence. For instance, in *Robinson* v. *Mollett*[14] the Court accepted the existence of a custom of the London tallow market, despite the fact it was peculiar to that market and did not exist on the Liverpool tallow market, where the customer usually traded.[15] It would, however, seem unlikely that the courts would accept a narrow definition of a market which did not reflect commercial reality.

3.2.5 Within the market in which a course of conduct is said to form a custom it must be shown that the conduct is both identifiable and uniform. It is these qualities that give the course of conduct the required certainty. The length of time which it takes for a course of conduct to acquire these qualities is not fixed. Frequent instances of the practice over a short period of time could be as effective as less frequent instances over a longer period. In the early period of a custom's development there may be inconsistencies in the course of conduct. However, before the course of conduct can become a custom it must exhibit a high degree of uniformity. Whether this degree of uniformity requires total consistency or some lesser measure is uncertain. For instance, in an Australian case where it was claimed that the payment of an insurance premium to a broker discharged the assured's debt to the insurer in accordance with a trade custom, the High Court of Australia held that the course of conduct was not sufficiently certain to be a custom.[16] This was despite the view of the trial judge that "instances where recourse was had to the assured are minute".[17] In contrast, in an English case it was the view of the court that the continued adherence of 85 per cent of Lancashire weaving mills to a custom was sufficient to maintain it.[18] It has been suggested that these cases may be reconciled if it is accepted that a higher degree of uniformity is required to prove that a custom has been created than is required to show its continued existence, the former requiring almost total uniformity, the latter a lesser, but still substantial, degree of uniformity.[19]

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[12] For example, warehousemen; see *Majeau Carrying Co. Pty. Ltd.* v. *Coastal Rutile Ltd.* (1972-3) 129 C.L.R. 48.

[13] For example, the custom of paying a term's fees in lieu of notice of an intention to withdraw a child from a private school; see *Mount* v *Oldham Corpn.* [1973] Q.B. 309.

[14] (1875) L.R. 7 H.L. 802.

[15] The custom was, however, held not to bind a principal who did not have knowledge of its existence.

3.2.6 It has been suggested that if a person is aware of a custom when entering into a contract he is bound by that custom whether or not it is notorious.[20] However, notoriety is usually included in general statements of the criteria which a practice must satisfy in order to constitute a custom.[21] To be notorious a custom need not be known to all the world, nor even to both parties to the contract.[22] However, it must be well known in the market to which it applies and readily ascertainable by any person entering into a contract of which it will form a part.[23]

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[16] *Con-Stan Industries of Australia Pty Ltd.* v. *Norwich Winterthur Insurance (Australia) Ltd.* (1986) 60 A.L.J.R. 294.

[17] *Norwich Winterthur Insurance (Australia) Ltd.* v. *Con-Stan Industries of Australia Pty Ltd.* [1981] 2 N.S.W.L.R. 879, 889-890.

[18] *Sagar* v. *H. Ridehalgh and Son Ltd* [1931] 1 Ch. 310.

[19] See, for example, Greig and Davis, *The Law of Contract* (1987), at 562-566.

[20] See, for example, Greig and Davis, *op. cit.*, at 567.

[21] See, for example, the statement in *Nelson* v. *Dahl*, para. 3.2.2, above.

[22] *Grissell* v. *Bristowe* (1868) L.R. 3 C.P. 112, 128, *per* Bovill C.J., reversed on the facts of the case, (1868) L.R. 4 C.P. 36; *Buckle* v. *Knoop* (1867) L.R. 2 Exch. 125, 129, *per* Kelly C.B., affirmed (1867) L.R. 2 Exch. 333.

3.2.7 The fact that a course of conduct is uniform, certain and notorious is not, in itself, enough to give rise to a binding custom. It must also be shown that the course of conduct was intended to be binding, and thus affect the legal rights and duties of the parties concerned. Courses of conduct followed merely as a matter of convenience or commercial exigency will not, without further evidence as to an intent to bind the parties, give rise to a custom. As the court said in *General Reinsurance Corpn.* v. *Forsakringsaktiebolaget Fennia Patria*:

> "There is ... a world of difference between a course of conduct that is frequently, or even habitually, followed in a particular commercial community as a matter of grace and a course which is habitually followed, because it is considered the parties concerned have a legally binding right to demand it. As Ungoed-Thomas J pointed out in *Cunliffe-Owen* v. *Teather & Greenwood* [1967] 1 W.L.R. 1421, 1438: 'What is necessary is that for a practice to be a recognised usage it should be established as a practice having binding effect'."[24]

Thus it must be proved that the course of conduct was intended to have a legally binding effect, and that compliance with it was the result of belief in a legal obligation to do so, rather than commercial convenience.

Regulatory Rules as Custom

3.2.8 Where a sphere of activity is regulated by a trade or professional association, or a body such as the governing bodies of various sports associations, the rules of that body are likely to be widely followed in relevant transactions as members of the body are bound by its rules.[25] The problems with which we are concerned usually arise in the relationship between a regulated firm and its customer rather than in the regulator-regulated relationship. If the customer is regulated by the same body as the firm no problem arises. Both customer and firm are bound by the rules of the regulator and any relationship between them is subject to those rules. If, on the other hand, the customer is not a member of the regulatory body it is necessary to consider to what extent he is bound by the rules of the regulator when dealing with the regulated firm. Part V of this paper considers whether the regulatory rules are effective as a matter of public law. We shall now consider whether they will be incorporated in the contract between a regulated firm and its customer as a matter of custom.

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[23] *Strathlorne SS Co. Ltd.* v. *Hugh Baird & Sons Ltd.* 1916 S.C.(H.L.) 134, 136, *per* Lord Buckmaster L.C.

[24] [1983] Q.B. 856, 874, *per* Slade L.J.

3.2.9 In relation to the provision of financial services, regulatory rules are found in two main areas. The first is on the actual markets themselves, for example, the Stock Exchange, the London Metal Exchange, the London International Financial Futures Exchange, the Futures and Options Exchange, or the International Petroleum Exchange, where the conduct of trade is regulated by the rules of that market. Most of the cases which consider whether regulatory rules bind third parties concern the rules of these bodies, and in particular the rules of the Stock Exchange. The second is in the rules of the bodies responsible for the regulation of investment business, that is the SIB and the four SROs.[26]

3.2.10 A wide basis of authority establishes that rules of the Stock Exchange will be incorporated into relevant contracts. The incorporation of the rules is probably dependent on the same principles as those applicable to trade customs,[27] although there is some authority that all Stock Exchange rules are binding regardless of their reasonableness and of whether or not they are known to the third party.[28] The former is the better view, as customers who deal or engage agents to deal for them on the Stock Exchange are in the same position as any outsider to a market. The rules of the Stock Exchange are written customs for dealing on that market, and should be no more binding on non-members than other customs. Although there is no explicit authority for the proposition, it is likely that the rules of the SROs will be subject to the same principles as those applicable to the rules of the Stock Exchange.

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[25] See, for example, *Doyle* v. *White City Stadium Ltd.* [1935] 1 K.B. 110.

[26] See paras. 2.5.1, 2.5.11, above. In the rest of this section we shall refer to these rules as "the rules of the SROs".

[27] *Duncan* v. *Hill* (1873) L.R. 8 Exch. 242, 248, *per* Blackburn J.; *Perry* v. *Barnett* (1885) 15 Q.B. 388; *Harker* v. *Edwards* (1888) 57 L.J.Q.B. 147; *Smith* v. *Reynolds* (1892) 66 L.T. 808; *Cunliffe-Owen* v. *Teather and Greenwood* [1967] 1 W.L.R. 1421, 1442, *per* Ungoed-Thomas J.

[28] *Benjamin* v. *Barnett* (1903) 8 Com. Cas. 244, 247-248, *per* Kennedy J.; *Union and Rhodesian Trust Ltd.* v. *Neville* (1917) 33 T.L.R. 245; *Forget* v. *Baxter* [1900] A.C. 467.

3.2.11 There are some restrictions on the incorporation of rules of practice into contracts. Rules which are the domestic concern only of the Stock Exchange do not bind non-members.[29] By analogy, rules of SROs which operate only in the domestic sphere will not be incorporated into contracts. There is authority for the proposition that rules cannot alter the substantive rights of non-member parties after a contract has been made.[30] This would happen where, for instance, a rule change occurs after a contract has been made. This authority was, however, questioned by Webster J. in *Shearson Lehman Hutton Inc.* v. *Maclaine Watson & Co. Ltd.*[31] where he held that the London Metal Exchange was entitled to change its rules so as to affect the contractual rights of non-members who had agreed to be bound by its rules and that the rule change did have this effect.

3.2.12 In general there should be little difficulty proving that rules of practice fulfil the factual requirements of trade customs. Their nature as written, well known, and binding on those firms which practice in the relevant markets means that there will usually be little doubt as to their certainty, uniformity and notoriety.

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[29] *Westropp* v. *Solomon* (1849) 8 C.B. 345; *Levitt* v. *Hamblet* [1901] 2 K.B. 53.

[30] *Levitt* v. *Hamblet* [1901] 2 K.B. 53; *Benjamin* v. *Barnett* (1903) 8 Com. Cas. 244; *Ponsolle* v *Webber* [1908] 1 Ch. 254; *Cunliffe-Owen* v. *Teather & Greenwood* [1967] 1 W.L.R. 1421.

[31] [1989] 2 Lloyd's Rep. 570, 589, 592.

Reasonableness

3.2.13 Once the existence of a trade custom has been established it will only be incorporated into a contract if it is reasonable. Reasonableness is a question of law.[32] As indicated above,[33] if a trade custom is held to be reasonable it will be incorporated into a contract to which it applies without regard to whether any party to the contract was ignorant of the custom in question. If a custom is held to be unreasonable it may still be incorporated into a contract if it comes within the 'usual allowance' exception, or if the parties consented to its incorporation.[34]

3.2.14 The test by which the reasonableness of a trade custom is assessed is usually expressed in wide, sweeping terms. Actual decisions on reasonableness are, therefore, made very much on a case by case basis. It has been said that a custom is unreasonable "unless it be fair and proper and such as reasonable, honest, and fair-minded men would adopt",[35] that "a usage founded on the general convenience of all parties engaged in a particular department of business, can never be said to be unreasonable",[36] and that "[t]here can be very few cases, where a custom has been sufficiently proved, in which a Court could hold that it was unreasonable, for that it must be convenient is shewn by the fact that it has been established and followed."[37] These general statements reflect the courts' tendency to support freedom of bargaining in commercial markets. This is quite justifiable in areas where the parties to a contract are experienced commercial entities dealing with general knowledge of the markets in question. However, where the relationship between the firm and customer is of a fiduciary nature it is harder to justify the variation, by a trade custom, of the duties imposed. We shall now consider whether a trade custom can modify fiduciary duties.

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[32] *Bradburn* v. *Foley* (1878) L.R. 3 C.P.D. 129, 135 *per* Lindley J.

[33] See para. 3.2.6, above.

[34] On these, see paras. 3.2.6, above and 3.2.23, 3.4.7-3.4.10, and 3.4.1, below.

[35] *Produce Brokers Co. Ltd.* v. *Olympia Oil and Cake Co. Ltd.* [1916] 2 K.B. 296, 298, *per* Horridge J.; *Paxton* v. *Courtnay* (1860) 2 F. & F. 131, *per* Keating J.

[36] *Grissell* v. *Bristowe* (1868) L.R. 4 C.P. 36, 48, *per* Cockburn C.J.

[37] *Moult* v. *Halliday* [1898] 1 Q.B. 125, 130, *per* Channell J.

3.2.15 As we have seen,[38] the scope of the duties owed by a fiduciary to his beneficiary varies, depending on the nature of the relationship. Where a custom purports to vary duties which are not fiduciary in nature it seems that the courts will apply the ordinary tests of reasonableness applicable in non-fiduciary circumstances. The main hurdle to incorporating such a custom is proving that it exists. Having shown this, the test of reasonableness will only rarely prevent a custom from being incorporated into a contract. *Benjamin* v *Barnett*[39] is an example of a custom varying the non-fiduciary duties of a fiduciary. A broker who had purchased a portion of a share order, but was unable to purchase other shares to fulfil the order, was held to be entitled to payment for the shares that he had purchased as it was the custom for brokers to fulfil their principal's orders by purchasing shares in this manner.

3.2.16 A custom which modifies a firm's fiduciary duty will usually be held to be unreasonable and will not bind the customer in the absence of his fully informed consent.[40] The court usually rejects the custom automatically without assessing whether it is in fact detrimental to the customer's interests. The court's attitude is exemplified by the judgment of Megaw J. in *Anglo-African Merchants Ltd.* v. *Bayley*.[41] This case concerned the practice of Lloyd's insurance brokers acting as agent for both their customers and also, in certain respects, the underwriters in the settling of claims. In concluding his judgment, Megaw J. said:

> "Even if it were established to be a practice well known to persons seeking insurance - not merely to insurers and brokers

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[38] See para. 2.4.8, above.

[39] (1903) 8 Com. Cas. 244.

[40] See, for example, *Robinson* v. *Mollett* (1875) L.R. 7 H.L. 802; *Fullwood* v. *Hurley* [1928] 1 K.B. 498, 504 *per* Scrutton L.J. Informed consent is considered in Section 3.4, below.

[41] [1970] 1 Q.B. 311.

> - I should hold the view ... that a custom will not be upheld by the courts of this country if it contradicts the vital principle that an agent may not at the same time serve two masters - two principals - in actual or potential opposition to one another: unless, indeed, he has the explicit, informed, consent of both principals."[42]

The statement of the requirement to avoid a conflict of duties unless express consent has been given as a "vital principle" that cannot be overcome by custom represents the least accommodating treatment of customs in conflict situations.

3.2.17 However in *North and South Co.* v. *Berkeley*,[43] a case involving the same custom but decided a year later, Donaldson J. appeared to apply a slightly less strict and more sophisticated test to trade customs in conflict circumstances. He expressed agreement with the judgment of Megaw J. and cited the same sources in support of the proposition that an agent must have express consent before acting for two parties in the same transaction, but described this as "the general principle".[44] He then went on to consider arguments that in this case there was justification for the custom allowing deviation from the general principle. He found that the custom was unreasonable as a broker who was acting for the underwriter could not fully perform the duties he owed to the insured.[45]

3.2.18 Although the decision in *North and South Co.* v. *Berkeley* held that the custom was not incorporated into the relevant contract, this case offers a more liberal judicial attitude towards the incorporation in contracts of customs that modify fiduciary duties than that exhibited in *Anglo-African Merchants Ltd.* v. *Bayley*. The implication of stating the rule requiring fully informed consent as a general principle, and then considering whether the current instance was a reasonable exception, is that a trade custom may allow a fiduciary to act in a situation which would otherwise cause a conflict, without the informed consent of his customer, if the custom is reasonable.

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[42] *Ibid.*, 323-324.

[43] [1971] 1 W.L.R. 470.

[44] *Ibid.*, 482.

[45] *Ibid.*, 482-3.

3.2.19 It is therefore necessary to consider when a custom which modifies fiduciary duties might be considered reasonable. In his judgment, Donaldson J. indicates the fact that the broker would be unable properly to represent his customer once he became privy to the underwriter's confidential information as a reason for finding the custom unreasonable. This is an example where detriment to the customer could, and is likely to, occur. It is, however, a feature of fiduciary law that a fiduciary is liable for breach of duty merely for being in a position where there is a "real sensible possibility" of conflict of interest or duty.[46] Thus there may be situations where, even though a position of conflict arises, a fiduciary's acts do not in any way harm his customer's interests. It is, therefore, necessary to consider whether a trade custom which permits a fiduciary to act in a position of conflict, but permits this only when the customer's interests are protected, is reasonable.

3.2.20 An example of such a situation occurred in the New South Wales case of *Jones* v. *Canavan*.[47] In this case stockbrokers acting on the instructions of a customer bought shares in a company listed on the Sydney Stock Exchange. They did not, however, buy shares on the exchange, but matched the purchase order with a sell order they had received from a second customer. This highlighted two conflicts. Firstly, there was a conflict between the duty owed to the first customer to obtain the best purchase price and that owed to the second to obtain the best selling price. Secondly, the brokers, in obtaining commission on both the sale and purchase of the shares, had an interest which conflicted with the duty they owed to the first customer to obtain the best price. The relevant trade custom included a method by which the price should be fixed by ascertaining the current market price of the shares. The New South Wales Court of Appeal held that the custom was reasonable and bound the customer because it provided for the fixing of a fair price with reference to the market position of the shares, and this price was the best the customer could have obtained. Although there were conflicts, the trade custom provided a method of resolving them which did not cause detriment to the customer's interest. The custom was therefore reasonable.

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[46] See para. 2.4.9, above.

[47] [1972] 2 N.S.W.L.R. 236.

3.2.21 It is clear from *Jones* v. *Canavan* that trade customs may allow fiduciaries to act in conflict situations without the informed consent of the beneficiary where the trade custom provides protection to the customer. Protection can arise in two different ways. Firstly, it may be considered that the trade custom actually eliminates any conflict (in this case due to the requirement to marry orders at market price), and thus there is no breach of duty when the firm acts in accordance with it. Alternatively, it may be considered that although the firm is in a position of conflict, nevertheless the trade custom provides an effective method for protecting the customer's interests. If the custom does not provide adequate protection it will fail the test of reasonableness and will not modify the firm's fiduciary duties.

3.2.22 It is possible to advance an argument on the basis of *Jones* v. *Canavan* that in certain circumstances a trade custom will vary the fiduciary duties which a firm owes to its customers. However, it is not a decision of an English court, and any argument that is advanced will be contrary to cases which state clearly that full disclosure and consent is the only method for derogating from a fiduciary's duty to avoid conflict.[48] The judgment of Donaldson J. in *North and South Trust Co.* v. *Berkeley*, provides some support for the argument, but, when it is read in conjunction with *Anglo-African Merchants Ltd.* v. *Bayley*, it cannot safely be relied upon.

Knowledge of a Custom

3.2.23 There are dicta in several of the cases that if a party is aware of an unreasonable trade custom when entering into a contract he is presumptively accepting that custom as part of the contract.[49] There is also authority for the proposition that if a party contracts with knowledge that a practice is regularly followed by the other party or parties in a particular trade or locality, this may amount to an implied assent to incorporate that practice in the contract, regardless of whether the practice fulfils the requirements of certainty and notoriety required by a custom.[50] Although knowledge of a custom may act so as to vary the non-fiduciary duties of a firm, it is unlikely that it will, without the informed consent of the beneficiary,[51] act so as to vary the firm's fiduciary duty. As discussed above,[52] it may be possible for a custom to vary a fiduciary duty if it protects the customer's interests. However, the English courts' extreme reluctance to allow customs to modify fiduciary duties means that it is very unlikely that an unreasonable custom which has this effect would be upheld on the basis only of the customer's knowledge.

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[48] As to which, see Section 3.4, below.

Provisional Conclusion

3.2.24 The incorporation of trade customs and rules of practice into contracts offers a method of allowing fiduciaries to act in breach of what would otherwise be their general law duties. This paper is, however, primarily concerned with fiduciary duties. Although it is possible to see an avenue down which the courts might move to permit the exemption of a fiduciary from liability where he acts in accordance with a custom which ensures that there is no detriment to the beneficiary's interests, at present English courts seem to favour the approach that conflicts of interest and duty are incompatible with the position of a fiduciary.[53] Thus a custom which permits a fiduciary to act in a conflict situation is unlikely to be upheld.

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[49] See, for example, *Robinson* v. *Mollett* (1875) L.R. 7 H.L. 802.

[50] *Brown* v. *Inland Revenue Commissioners* [1965] A.C. 244, 266, *per* Lord Upjohn; *British Crane Hire Corpn. Ltd.* v. *Ipswich Plant Hire Ltd.* [1975] Q.B. 303.

[51] As to which, see Section 3.4, below.

[52] See paras. 3.2.16-3.2.22, above.

[53] See para. 3.2.16, above.

3.2.25 It must be remembered when considering the effect of trade customs that they are a method of incorporating into contracts the generally accepted practices of the markets to which they relate. Although the courts do not appear to have considered this point, it seems that once a custom is incorporated into a contract, if it operates as an exclusion clause it will be subject to the general limitations on exclusion clauses, for example, where applicable, UCTA. These limitations are considered in section 3.3, below.

3.3 Exclusion Clauses

3.3.1 In this section we shall consider: the types of clauses that may be used to modify or exclude fiduciary duties, whether seeking to modify them may itself be a breach of duty, the rules of construction to which such clauses are subject, controls imposed by statute, and the relevance of regulatory rules to these issues. We shall then set out our provisional assessment of the efficacy of such clauses for resolving the problems with which we are concerned.

3.3.2 The exclusion clauses which may be incorporated in contracts between fiduciaries and beneficiaries may conveniently be divided into three types (although there may be some overlap between them). First, there are straightforward clauses which seek to exclude or limit liability for breach of duty. Secondly, there are clauses which seek to (re)define the relationship between fiduciary and beneficiary, thus preventing the accrual of certain fiduciary obligations and rights or delimiting them.[54] An example of this type of clause (such clauses will hereinafter be referred to as "duty defining clauses") is provided by clauses which state that the fiduciary may act as principal or that no fiduciary duties arise other than those expressly set out in the agreement. Thirdly, there are clauses which purport to make generalised advanced disclosures[55] of material interests which the fiduciary may have, or of possible conflicts of interest and duty which may arise during the course of the fiduciary relationship, (hereinafter referred to as "disclosure clauses"). The responses to the Issues Questionnaire revealed that duty defining and disclosure clauses are commonly incorporated in contracts used in the course of financial services business. We shall concentrate on these clauses in the discussion which follows.

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[54] See generally Coote, *Exception Clauses* (1964); *Scott on Trusts* (4th ed., 1988), at para. 222.1.

3.3.3 Regulatory rules have a number of roles in determining the effectiveness of contractual techniques to modify or exclude fiduciary duties. First, they are part of the factual matrix against which a contract is construed.[56] Secondly, as we shall see,[57] they may be relevant to the operation of the reasonableness test under UCTA in two ways. If an exclusion clause reflects the provisions of a regulatory rule, this will be a factor pointing to its reasonableness, but if such a clause attempts to exclude liability in circumstances where the regulatory rules impose a duty, this will be a factor pointing to its unreasonableness. Thirdly, we have seen that it is easier to incorporate a term into a contract if it reflects trade practice, whether this is done by establishing a custom or trade usage or otherwise,[58] and regulatory rules affecting trade practice are likely to be similarly incorporated into the contract with the customer.

Might Securing Exemption Itself be a Breach of Duty?

3.3.4 An important preliminary question when considering the extent to which exemption clauses are an effective means of avoiding liability for breach of fiduciary duty is whether the very fact of securing an exemption or modification of the duty is itself a breach of duty. A fiduciary relationship may exist between the parties prior to, or at the time of, the formation of the contract, for example, where one of the parties is the solicitor of the other or his financial adviser. In such circumstances the inclusion by the fiduciary in its contract with the beneficiary of a clause exempting it from liability for breach of reasonable duties may, in itself, amount to breach of fiduciary duty in the absence of the informed consent of the beneficiary.[59] Whether or not it does would depend on the precise nature of the relationship between the parties. We have already seen that there are many different types of fiduciary relationship not all of which give rise to the same components of fiduciary duty and not all of which warrant the same kind of judicial monitoring of transactions.[60] If the duties owed to the beneficiary and the contents of the exclusion clause are such that the inclusion of the clause amounts to breach of duty, the fiduciary should not be able to retain the benefit of that breach and should not be able to rely on the exclusion clause.[61]

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[55] The efficacy of disclosure and consent provisions will be examined in detail in Section 3.4, below. Although the line between a clause making general disclosure and an exclusion clause can be fine, in this section we are concerned only with their status as exclusion clauses.

[56] *Prenn* v. *Simmonds* [1971] 1 W.L.R. 1381. For an example, see para. 3.3.18, below.

[57] Paras. 3.3.26 and 3.3.35, below.

[58] Section 3.2, above. See also *British Crane Hire Corpn. Ltd.* v. *Ipswich Plant Hire Ltd.* [1975] Q.B. 303.

Do Fiduciaries Have a Minimum Core Level of Duty?

3.3.5 Where the parties did not have a pre-existing fiduciary relationship which would be breached by the inclusion of an exemption clause, and the contract was not affected by a vitiating factor such as undue influence[62] or duress, it is necessary to consider whether they are free to delineate their respective rights and obligations by contract, subject only to the statutory and common law rules on exclusion clauses, or whether the fiduciary nature of the relationship created by the contract imports some intrinsic minimum level of duty from which it is impossible to derogate.

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[59] *Restatement of Trusts* (2nd ed., 1959), at para. 222(3); Shepherd, *The Law of Fiduciaries* (1981), at 104-5; Matthews, "The Efficacy of Trustee Exemption Clauses in English Law", [1989] Conv. 42, at 52. As to informed consent, see Section 3.4, below.

[60] *Re Coomber* [1911] 1 Ch. 723, 728, *per* Fletcher Moulton L.J. (using the term "interference") and see para. 2.4.8, above.

[61] Although well established in the United States (*Scott on Trusts* (4th ed. 1988), at para. 222.4) there appears to be no English decision to this effect. However, it appears correct in principle and the reasoning in analogous contexts concerning trustees and fiduciaries provides support for judicial scrutiny of the terms of the transaction. See, for instance, *Wright* v. *Morgan* [1926] A.C. 788, 797; *Ex p. Lacey* (1802) 6 Ves. Jun. 625, 626 (albeit in the context of the dissolution not the modification of the relationship). See also *Wright* v. *Carter* [1903] 1 Ch. 27, 50, *per* Vaughan Williams L.J.; *Allison* v. *Clayhills* [1907] 97 L.T. 709, 712; *Electrical Trades Union* v. *Tarlo* [1964] Ch. 720. See further *Cordery*, at 10-11, 13-14; Sheridan, *Fraud in Equity* (1957), at 111; Matthews, above, at 53.

[62] i.e. actual undue influence. If there was a presumption of undue influence it is likely that the relationship would be one in respect of which it is arguable (on the lines above) that the inclusion of the clause would be a breach.

3.3.6 It is clear that trustees are subject to a core level of duty from which they cannot be exempted. Although the application of the "no-conflict" rule to a trust can be modified by the trust deed or with the assent of the beneficiaries,[63] a trust presupposes certain correlative rights and obligations as between beneficiary and trustee. If a person described as a trustee is exempted from all duties, he is not a trustee.[64] As well as this core level of duty it seems that a trustee may not exclude liability for "wilful default". There is, however, uncertainty as to whether liability for gross negligence can be excluded. Section 30(1) of the Trustee Act 1925 provides that a trustee "shall be answerable and accountable only for his own acts, receipts, neglects, or defaults ... nor for any other loss unless the same happens through his own wilful default". In *Re Vickery*, Maugham J. held that "wilful default" did not include gross negligence and precluded liability for conduct short of reckless indifference.[65] However, this restricted meaning of "wilful default" has been criticised[66] as departing from its traditional trust law meaning[67] and as unnecessary since, on the facts of that case, there appears to have been no negligence by the trustee.[68] It also fails to take account of the growing distinction between the duties of professional and lay trustees.[69] Moreover, *Re Vickery* does not deal with a contrary line of authority on clauses exculpating trustees for "wilful default" which it had been assumed the legislative precursors of section 30[70] had put into statutory form. These cases support the proposition that trustees cannot be exempted from liability for breach of trust arising from gross negligence or bad faith.[71] It has been argued that since *Re Vickery* they should only be regarded as prohibiting the exclusion of liability for conscious negligence or breach of duty or reckless indifference,[72] but this does not give sufficient recognition to the criticisms of Maugham J.'s judgment. However, although there is modern Commonwealth authority for the view that a trustee must be held responsible for any loss resulting from his gross negligence, regardless of any provision in the trust instrument relieving him from such liability,[73] the position in England must be regarded as less certain.

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[63] *Dale* v. *Inland Revenue Commissioners* [1954] A.C. 11, 26, 27 (rejecting Evershed M.R. who, in the C.A., [1952] Ch. 704, 716, said trusteeship "involves a denial of any right to make a profit out of its performance");*Boulting v. Association of Cinematograph, Television and Allied Technicians* [1963] 2 Q.B. 606, 634-7; *Space Investments Ltd.* v. *Canadian Imperial Bank of Commerce Trust Co. (Bahamas) Ltd.* [1986] 1 W.L.R. 1072, 1073-4. For an example of a provision in a trust deed sanctioning actual and potential conflicts of interest, see Prime, *International Bonds and Certificates of Deposit* (1990), at 320.

[64] Ford & Hardingham, "Trading Trusts: Rights and Liabilities of Beneficiaries" in *Equity and Commercial Relationships* (1987), (ed. Finn), at 48, 57. See also Matthews, "The Efficacy of Trustee Exemption Clauses in English Law", [1989] Conv. 42 at 47.

[65] [1931] 1 Ch. 572, 583-4.

[66] Underhill and Hayton, *Law Relating to Trusts and Trustees* (14th ed., 1987), at 552. See also Jones, "Delegation by Trustees: A Reappraisal", (1959) 22 M.L.R. 381 at 390-393; Stannard, "Wilful Default", [1979] Conv. 345.

[67] See, for example, *Re Chapman* [1896] 2 Ch. 763, 776, *per* Lindley L.J.: "wilful default ... includes want of ordinary prudence on the part of the trustees".

3.3.7 It is not clear to what extent these limitations on exclusion apply to fiduciary relationships other than those between trustees and beneficiaries.[74] Where the relationship arises by contract, fiduciaries, like all contracting parties, may not exclude themselves from liability for their own fraud[75] or illegality[76]. If "fraud" in this context is confined to common law fraud this is not a severe restriction. However, if it includes equitable fraud, it will prevent the exclusion of a wide range of conduct.[77] In principle, given equity's prophylactic role and underlying policies, there would seem no reason to confine the restriction to common law fraud: it would be odd for a court to accept that persons could exempt themselves from liability for unconscionable behaviour.[78] It has been held that the promoter of a company cannot contract out of the duty not to make a profit out of the promotion without disclosing it to an independent board or in the prospectus[79] and it has been suggested that any attempt by fiduciaries to exempt themselves from liability for a deliberate breach of duty would be similarly ineffective.[80] On the question of what constitutes deliberate breach, there is authority that nothing short of "reckless indifference" amounts to "wilful default" and there is therefore some doubt as to the position of gross negligence.[81]

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[68] [1931] 1 Ch. 572, 584-5. There had been no breach of the trustee's duty of prudent supervision.

[69] *National Trustee Co.* v. *General Finance Co.* [1905] A.C. 373; *Re Waterman's Will Trust* [1952] 2 All E.R. 1054. *Bartlett* v. *Barclays Bank Trust Co. Ltd. (No. 1)* [1980] Ch. 515, 534, *per* Brightman L.J.; *Dorchester Finance Co. Ltd.* v. *Stebbing* [1989] B.C.L.C. 498, 502, *per* Foster J. See also, 23rd Report of the Law Revision Committee (1982) Cmnd. 8733, paras. 2.12-2.16.

[70] Law of Property (Amendment) Act 1859 s. 31, replaced by Trustee Act 1893, s. 24, replaced by Trustee Act 1925, s. 30(1).

[71] *Wilkins* v. *Hogg* (1861) 5 L.T. 467, 470; *Pass* v. *Dundas* (1880) 43 L.T. 665; *Wyman* v. *Paterson* [1900] A.C. 271, 281, 287.

[72] Ford & Hardingham, in *Equity and Commercial Relationships* (1987), (ed. Finn), at 57. However, cf. Ford & Lee, *Principles of the Law of Trusts* (2nd ed., 1990), at para. 1806.

[73] *Re Poche* (1984) 6 D.L.R. (4d) 40, 55. See also Ford & Lee, above, at para. 1806.

[74] If the cases cited in para. 3.3.4, n. 61 are relevant, they should in principle apply to all fiduciary relationships. However, cf. the distinction made between trustees and other fiduciaries in *Re City Equitable Fire Insurance Co.* [1925] Ch. 407, 523-524.

3.3.8 As we have already noted,[82] not all fiduciary relationships give rise to the same level of duties. Situations in which, quite apart from any term in the contract constituting the relationship, a particular duty does not arise, must be distinguished from those where the duty does arise. In the former, where the duty does not arise, a statement which may appear to limit that type of duty cannot operate as an exclusion. Where particular duties would have arisen but for an exclusion clause, one of two possible approaches may be adopted.

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[75] *S Pearson & Son Ltd.* v. *Dublin Corporation* [1907] A.C. 351, 353, 362; *Boyd & Forrest* v. *Glasgow and S.W. Ry. Co.* 1915 S.C. 20, 36 (H.L.). See also *Re Banister* (1879) 12 Ch. 131, 136, 142-143, 149. Cf. *Garden Neptune Shipping Ltd.* v. *Occidental Worldwide Investment Corpn.* [1990] 1 Lloyd's Rep. 330, 335; *Tullis* v. *Jacson* [1892] 3 Ch. 441 (albeit in respect of a third party's alleged fraud and subject to Scrutton L.J.'s criticism in *Czarnikow* v. *Roth, Schmidt and Co.* [1922] 2 K.B. 478, 488).

[76] *Czarnikow* v. *Roth, Schmidt and Co., ibid.*

[77] Sheridan, *Fraud in Equity* (1957); Meagher, Gummow and Lehane, *Equity: Doctrines and Remedies* (2nd ed., 1988), ch. 12.

[78] See also para. 3.3.4, above.

[79] *Re Olympia Ltd.* [1898] 2 Ch. 153, 179-180, affirmed *sub nom Gluckstein* v. *Barnes* [1900] A.C. 240.

[80] Treitel, *The Law of Contract* (8th ed., 1991), at 224.

[81] *Re City Equitable Fire Insurance Co. Ltd.* [1925] Ch. 407, but see para. 3.3.6, above, for criticism of this.

[82] See para. 2.4.8, above.

3.3.9 The first would be to consider, when determining the rights and obligations of the parties, the essence of the relationship, and to refuse to give effect to clauses which are incompatible with it. This status based approach[83] would be similar to the position in relation to trustees set out above, although the determination of what is incompatible would be difficult. Apart from trustees, the main categories of fiduciaries with which we are concerned are agents and advisers. Dr Reynolds states that agency is an exception to the disinclination of the common law to ascribe special rules for types of contract or types of function and suggests that "[i]f the essence of agency is that one person is entrusted with the power to act for another in that other's interest, a clause enabling him without warning on a particular occasion to act in his own interest, *or* in the interest of another principal, seems plainly inconsistent with the whole nature of fiduciary responsibility."[84] In the context of stock exchange dealings, he suggests that terms, such as clause 30 of the IFMA and BMBA standard conditions for discretionary fund management,[85] which purport to enable a broker without warning to act as principal rather than agent, are "quite inconsistent with the role of broker and ineffective except against a principal who has assented to the changed relationship on this particular occasion."[86] The authority given for this proposition is *Robinson* v. *Mollett*[87] which concerned the effect of a trade custom rather than an exclusion clause. However, that case highlighted the unacceptability of changing the substance of a relationship without the fully informed consent of the other party.[88]

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[83] It differs from the "main purpose" rule of construction, on which see below, because it operates substantively.

[84] "The Law of Agency in Relation to Intermediaries," in *The Regulation of Financial and Capital Markets* (Singapore 1991), at 139-140.

[85] Edition IFMA/BMBA2, 1991; see para. 2.2.7, above.

[86] N. 84, above, although he may be confining his prohibition to where the broker charges commission as well as taking a profit on the "turn". See also *Bowstead on Agency* (15th ed., 1985), at 5-7.

[87] (1874) L.R. 7 H.L. 802, para. 3.2.4, above.

3.3.10 The second approach would be to state that where a relationship is created by contract, trust deed,[89] partnership agreement or other similar instrument, and there was no pre-existing fiduciary relationship between the parties, the court must have regard to all the terms of the contract or instrument when determining whether the relationship is fiduciary and, if so, the scope of the fiduciary's duties.[90] In particular, although the court will have regard to substance and not form, it must give effect to duty defining clauses, which show that no partnership or agency relationship is created[91] or that a particular fiduciary duty is excluded. Thus, on this approach clear clauses would abrogate, for instance, the rules concerning no profit,[92] self-dealing,[93] or the disclosure of all relevant information to the customer.[94] The question of breach would not arise. The parties to a consensual relationship would be free to set out the parameters of their respective rights and duties by contract or other instrument, subject to any statutory provisions to the contrary.[95]

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[88] See also Flannigan, "Fiduciary Obligations in The Supreme Court", (1990) 54 Sask. L. Rev. 45, 69. See Section 3.4, below, on informed consent.

[89] See *Re Duke of Norfolk's Settlement Trusts* [1982] Ch. 61, discussed at para. 3.3.30, below, on the rejection of the contractual analysis of a trustee's right to remuneration under a charging clause in a trust instrument.

[90] Meagher, Gummow, Lehane, *Equity Doctrines & Remedies* (2nd. ed., 1984), at 134, 146; Ford and Lee, *op. cit.*, at paras. 972, 1806; Powell, *The Law of Agency* (2nd ed., 1961), at 302; Seavy, *Studies in Agency*, at 69-70. See also *Aas* v. *Benham* [1891] 2 Ch. 244; *Birtchnell* v. *Equity Trustee Executors & Agency Co. Ltd.* (1929) 42 C.L.R. 384; *New Zealand Netherlands Society 'Oranje' Incorporated* v. *Kuys and another* [1973] 1 W.L.R. 1126; *Jirna Ltd.* v. *Mister Donut of Canada Ltd.* [1975] 1 S.C.R. 2; *Molchan* v. *Omega Oil & Gas Ltd.* [1988] 1 S.C.R. 348.

[91] *Jirna Ltd.* v. *Mister Donut of Canada Ltd.*, above; *Molchan* v. *Omega Oil and Gas Ltd.*, above.

[92] *Dale* v. *I.R.C.* [1954] A.C. 11, 27; *Space Investments Ltd.* v. *Canadian Imperial Bank of Commerce Trust Co. (Bahamas) Ltd.* [1986] 1 W.L.R. 1072, 1074.

[93] *Movitex Ltd.* v. *Bulfield* [1988] B.C.L.C. 104, 120.

[94] In the case of those who are trustees, information obtained in one fiduciary capacity *may* be used in another unless it is confidential (*Boardman* v. *Phipps* [1967] 2 A.C. 46, 107, 128-9; *North and South Trust Co.* v. *Berkeley* [1971] 1 W.L.R. 470) and clauses may seek to make it clear that the trustee is not obliged to disclose or use such non-confidential information. In the case of banks, the bankers' duty of confidentiality may mean that there is no need for such clauses; see *Tournier* v. *National Provincial and Union Bank of England* [1924] 1 K.B. 461, but cf. *Woods* v. *Martins Bank Ltd.* [1959] 1 Q.B. 55, 72-73 although (a) *Tournier's case* was not considered, and (b) no such clause purporting to limit the bank's duty to disclose existed.

3.3.11 Although it is not clear which approach the courts will adopt we believe that the second should prevail. The first approach does not take account of the fact that in the most intense form of fiduciary relationship, trusteeship, the "no profit" and the "no conflict" rules can be modified.[96] The position of other fiduciaries such as agents and advisers should be *a fortiori*. Secondly, it does not take account of the fact that it is not inconsistent with the status of agency for an intermediary to be empowered to keep for himself the proceeds of sale above a specified price.[97] Thirdly, it smacks of the now rejected doctrine of fundamental breach[98] and may not give adequate weight to all the terms of the agreement. In any case the determination of the "essence" or "substance" of a relationship will depend on its factual context. The court will have regard to the general mercantile structure within which a relationship arises, a structure of relationship and expectation built up from accepted custom and methods of dealing.[99] Where a person is clearly described as a "broker/dealer" in the context of a widespread practice of dual capacity in the market it may be difficult to conclude that the "substance" of the relationship is that he is an agent.[100]

3.3.12 Although many of the cases supporting the second approach are not English, they seem to us to accord with the general approach of English courts and to be correct in

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95. For example, Companies Act 1985, s. 310.

96. See para. 3.3.6, above.

97. *Re Smith, ex p. Bright* (1879) 10 Ch. 566, 570, *per* Jessel M.R. Cf. *Morgan* v. *Elford* (1876) L.R. 4 Ch. 352, 364, *per* Malins V-C., 384, *per* James L.J. See also *Singer Co. (U.K.) Ltd.* v. *Tees and Hartlepool Port Authority* [1988] 2 Lloyd's Rep. 164, 167.

98. See para. 3.3.14, below.

99. *Branwhite* v. *Worcester Works Finance Ltd.* [1969] 1 A.C. 552, 586, *per* Lord Wilberforce. On custom, see Section 3.2, above.

100. See para. 3.3.12(iii), below.

principle. The adoption of this approach is unlikely to leave the customer with insufficient protection because:

(i) A strict approach will be taken to the construction of exclusion clauses and general words are unlikely to exclude all aspects of fiduciary duty.[101] It is likely that the courts will more readily accept that fiduciary duties have been modified or excluded in the context of a commercial agreement between parties of equal status,[102] or where the arrangements in question are common in the particular industry,[103] than where the beneficiary is commercially inexperienced. Whether a court does so may depend on whether the fiduciary is paid for its services and advertises itself as carrying on a specialised business, for example trust management.[104]

(ii) Limited fiduciary duties and the exclusion of a particular rule are likely to be held to exclude that rule in its automatic nature only; the fiduciary is still likely to be held to owe duties of good faith in respect of a particular transaction. Although the disability rule, which automatically renders transactions carried out by company directors in breach of the self-dealing rule voidable, can be modified,[105] the director must still act in the best interests of the company. Again, it has been said that while an appropriate clause may empower a corporate trustee to undertake activities which would not otherwise be available to it, the activities must not be performed in such a way as to prejudice the beneficiaries.[106] In any event, the court might be more hostile to a clause which went further than simple modification of the self-dealing rule, for example by negating the duty to make full disclosure.

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[101] *Midcon Oil and Gas Ltd.* v. *New British Dominion Oil Co. Ltd.* [1958] S.C.R. 314; (1958) 12 D.L.R. (2d) 705, 722-3, 725.

[102] See, for example, *The New Zealand and Australian Land Company* v. *Watson and Another* (1881) 7 Q.B. 374, 382; *Keith Henry & Co. Pty. Ltd.* v. *Stuart Walker & Co. Pty. Ltd.* (1958-59) 100 C.L.R. 342; *Lac Minerals Ltd.* v. *International Corona Resources Ltd.* [1989] 2 S.C.R. 574, 595.

[103] See paras. 3.4.7-3.4.10, below, (lesser duties of disclosure for usual allowances) and Section 3.2, above, (trade custom). See also cases cited in Finn, *Fiduciary Obligations* (1977), at para. 491 and *Aston* v. *Kelsey* [1913] 3 K.B. 314, 322.

[104] It is clear that paid trustees, for example trust companies which carry on and advertise their specialised business of trust management, owe a higher duty of care than unpaid trustees, (*Re Waterman's Will Trusts* [1952] 2 All E.R. 1054, 1055; *Bartlett* v. *Barclays Bank Trust Co. Ltd.* (Nos. 1 & 2) [1980] Ch. 515, 534) but are more likely to utilise widely drawn exclusion clauses, (see, for example Matthews, "The Efficacy of Trustee Exemption Clauses In English Law", [1989] Conv. 42, 43; Kenny, "The Reasonable Trustee", (1982) 126 S.J. 631. Several commentators have drawn attention to the unacceptability of such terms, (Bogert, *Trusts and Trustees* (2nd ed.), at para 542; *Scott on Trusts* (4th ed., 1988), at para 222.3; Ford and Lee, *The Law of Trusts* (2nd ed., 1991), at para. 1802; Ontario Law Reform Committee, *Report on The Law of Trusts* (1984), Vol. 1, at 40) and it is possible that a court would be more sympathetic to the first approach, (para. 3.3.9, above), in such cases.

(iii) In determining whether a relationship is fiduciary and, if so, the scope of the fiduciary's duties, the court will have regard to the substance of the transaction and not its form. Thus, labels such as declarations in standard form contracts that a firm is or is not an "agent", a "broker", an "adviser", or a "fiduciary" will not be conclusive.[107] The nature of the relationship will be determined from the whole instrument construed in the light of its commercial context and not from a few words: "[e]very word ought to have its weight and ought to be well considered".[108] The parties will be held to have consented to a particular relationship if, as has been said in the context of the creation of agency, either expressly or by implication from their words and conduct, "they have agreed to what amounts in law to such a relationship, even if they do not recognise it themselves and even if they have professed to disclaim it".[109] Thus, it was said of an instrument that "the use of the word 'lend' and the reference to [the Partnership Law Amendment Act 1855] are ... a mere sham - a mere contrivance to evade the law of partnership which cannot alter the real nature of the transaction."[110] A court will have regard to the entirety of the obligations undertaken by a firm and the reality of the relationship between it and the customer in determining the scope of fiduciary duties. A description of the firm as dealing solely on an "execution only" basis will not be conclusive if advisory services are also offered and advisory obligations also undertaken.[111] The Core Rules are also concerned to ensure that the status of the firm is clearly disclosed to customers.[112]

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[105] *Movitex Ltd.* v. *Bulfield and Others* [1988] B.C.L.C 104, 120-121.

[106] Prime, *International Bonds and Certificates of Deposit* (1990), at 32.

[107] *Benjamin's Sale of Goods* (3rd ed), at para. 49; *Bowstead on Agency* (15th ed., 1985), at 22. It is possible that some of the Canadian cases have given too much weight to labels; see Flannigan, "Fiduciary Obligation in the Supreme Court", (1990) 54 Sask. L. Rev. 45.

[108] *Ex p. Delhasse* (1877) 7 Ch. 511, 525, *per* James L.J.

[109] *Garnac Grain Co. Inc.* v. *H.M.F. Faure & Fairclough Ltd.* [1968] A.C. 1130n, 1137, *per* Lord Pearson. See also *Livingstone* v. *Ross* [1901] A.C. 327.

3.3.13 We have seen that a fiduciary cannot exclude liability for fraud, deliberate breach of duty and possibly gross negligence. Beyond that, apart from certain particular cases,[113] it is unclear whether any, and if so what, restrictions operate as a matter of fiduciary law to prevent fiduciaries from contracting out of or modifying their fiduciary duties, particularly where no prior fiduciary relationship existed and the contract seeks to define the duties of the parties rather than explicitly to exclude liability. We incline to the view that there are no such restrictions and invite views on this question. On the assumption that fiduciary law itself does not limit the parties' contractual freedom save in respect of fraud, deliberate breach of duty, and possibly gross negligence we now turn to the general law governing exclusion clauses, both common law and statutory, to determine the extent to which it restricts a fiduciary from ousting or modifying its duties and liabilities. This analysis assumes that the rules on incorporation of such clauses into the contract whether by custom[114] or by notice[115] have been satisfied. We shall first consider the common law rules since if, on its true construction, a clause is ineffective to exclude or modify a duty, there is no need to turn to the statutory controls over exemption clauses. The clause will simply not apply.

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[110] *Ex p. Delhasse* (1877) 7 Ch. 511, 526, *per* James L.J., 532, *per* Baggallay L.J. See also *Weiner* v. *Harris* [1910] 1 K.B. 285, 290 (whether agent or buyer); *Calder* v. *H. Kitson Vickers & Sons (Engineers) Ltd.* [1988] I.C.R. 232. See generally, *Lindley and Banks on Partnership* (16th ed., 1990), para. 5.05. Note also the approach of the courts to artificial schemes to avoid tax (e.g. *Furniss* v. *Dawson* [1984] A.C. 474) or the application of protective legislation, in particular the Rent Acts (e.g. *Antoniades* v. *Villiers* [1990] 1 A.C. 417 - whether licensee or lessee - but cf. *Hilton* v. *Plustitle Ltd.* [1989] 1 W.L.R. 149). See also *Chase Manhattan Equities Ltd.* v. *Goodman* [1991] B.C.C. 308; *Welsh Development Agency* v. *Export Finance Co. Ltd.* (C.A.) [1991] B.C.L.C. 936. On the limits of the doctrine of sham, see *Buchmann* v. *May* [1978] 2 All E.R. 993 and see generally Nicol, "Outflanking Protective Legislation - Shams and Beyond", (1981) 44 M.L.R. 21; Bright, "Beyond Sham and into Pretence", (1991) 11 O.J.L.S. 136.

[111] Here we are concerned with the initial nature of the relationship which is to be distinguished from the situation where it evolves over time, as to which see para. 3.3.22, below.

[112] Core Rule 11. See also SIB, Retail Regulation Review, Discussion Paper 3, *Disclosure* (October 1991), at 12-14; SIB, Retail Regulation Review, Consultative Paper 60, *Disclosure, Polarisation, and Standards of Advice* (March 1992), at 17-19.

[113] Such as trustees and company directors; see para. 3.3.6 and n. 63, above.

Common Law Rules of Construction[116]

3.3.14 The courts have developed a number of overlapping principles of construction as a means of controlling the use of exemption clauses. To be effective, such clauses must be clearly and unambiguously expressed since they are strictly construed against the person who drafted them or seeks to rely on them; i.e. contra proferentem.[117] This strictness remains although, since the enactment of UCTA, the courts have indicated certain changes of emphasis. For instance, it has been said that limitation clauses are not regarded by the courts with the same hostility as exclusion clauses.[118] Again, the House of Lords has reaffirmed that it is possible to exclude liability for fundamental breach[119] and deliberate breaches of contract.[120]

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[114] See Section 3.2, above.

[115] On these rules see Treitel, *The Law of Contract* (8th ed., 1991), at 197-202; *Cheshire, Fifoot and Furmston's Law of Contract* (12th ed., 1991), at 157-164. In particular note that where the customer's signature to the agreement is not obtained, as often happens in relation to business customers, the terms may be incorporated if notice of the term is inferred from a course of dealing even where there is no actual knowledge of the term; *J. Spurling Ltd.* v. *Bradshaw* [1956] 1 W.L.R. 461; *McCutcheon* v. *David MacBrayne Ltd.* [1964] 1 W.L.R. 125. See also *British Crane Hire Corpn. Ltd.* v. *Ipswich Plant Hire Ltd.* [1975] Q.B. 303.

[116] See *Chitty on Contracts* (26th ed., 1989), at paras. 945-970; *Halsbury's Laws of England* (4th ed.) Vol. 9, at paras 367, 370-377; Treitel, *The Law of Contract* (8th ed., 1991), at 202-223; Yates and Hawkins, *Standard Business Contracts: Exclusion Clauses and Related Devices* (1986), ch. 4 for a detailed account. See also *Acme Transport Ltd.* v. *Betts* [1981] 1 Lloyd's Rep. 131, 134, *per* Cumming-Bruce L.J.

[117] *Ailsa Craig Fishing Co. Ltd.* v. *Malvern Fishing Co. Ltd.* [1983] 1 W.L.R. 964, 966, per Lord Wilberforce.

[118] *Ailsa Craig Fishing Co. Ltd.* v. *Malvern Fishing Co. Ltd., ibid.*, 966, 970; *George Mitchell (Chesterhall) Ltd.* v. *Finney Lock Seeds Ltd.* [1983] 2 A.C. 803, 814.

3.3.15 However, there remains "a presumption or prima facie rule that general words will not exclude liability for certain very serious breaches"[121] which can only be displaced if the words of the clause are "sufficiently clear".[122] Generally, broad wording which may appear to exonerate even the most serious breaches, will not be construed as having such effect if this would "lead to absurdity", or "would defeat the main object of the contract".[123] Similarly, the court will be slow to interpret a clause as completely negating one party's obligations and liabilities, thus reducing the contract to "a mere declaration of intent".[124] Clauses such as these may be distinguished from clauses which define the duties of the parties so that no duty arises or the duty is modified so that there is no breach of contract.[125] It has been held that the strict construction rule does not apply to duty defining clauses[126] but it remains to be seen whether the court's reluctance to allow such contractual devices to evade liability under UCTA[127] will carry over into its application of common law principles to attempts to avoid fiduciary duties. Finally, clear words must be used to exclude liability for negligence unless the clause is wide enough to comprehend negligence, and it is not susceptible of being interpreted as exempting the contracting party from other forms of liability.[128] Thus, where a firm may be liable irrespective of negligence, for instance, for breach of fiduciary duty, a clause purporting to exclude the no-conflict rule, the no-profit rule, or any other strict or disabling rule[129] is unlikely to be held effective to exclude liability for negligence as well.

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[119] It is now clear that the doctrine of fundamental breach is a rule of construction and not a rule of law; *Photo Production Ltd.* v. *Securicor Transport Ltd.* [1980] A.C. 827, 843.

[120] *Suisse Atlantique Société d'Armement Maritime S.A.* v. *N.V. Rotterdamsche Kolen Centrale* [1967] 1 A.C. 361, 435 (hereafter "*Suisse Atlantique*").

[121] Treitel, *op. cit.*, at 207. For examples of the application of this presumption see pp. 207-215.

[122] *Ibid.*

[123] *Suisse Atlantique*, n. 120, above, at 398. See further, Treitel, *op. cit.*, at 215, 218.

[124] *Suisse Atlantique*, n. 120, above, at 432.

[125] For example, *G.H. Renton & Co. Ltd.* v. *Palmyra Trading Corpn. of Panama* [1957] A.C. 149 and para. 3.3.10, above.

[126] *The Angelia* [1973] 1 W.L.R. 210, 231 (disapproved on another point in *The Nema* [1982] A.C. 724); *Kenyon, Son & Craven Ltd.* v. *Baxter Hoare & Co. Ltd.* [1971] 1 W.L.R. 519, 522. See also Treitel, *op. cit.*, at 220.

[127] See para. 3.3.28, below.

3.3.16 As noted above,[130] since the enactment of UCTA, the courts have been more willing to adopt a straightforward approach to the construction of exclusion clauses. Where the statute applies, as we shall see, the clause will either be prohibited or subject to a reasonableness test whatever it purports to do on its true construction. Where the statute does not apply, "... in commercial matters generally, when the parties are not of unequal bargaining power, and when risks are normally borne by insurance, ... there is everything to be said, and this seems to have been Parliament's intention, for leaving the parties free to apportion the risks as they think fit and for respecting their decisions".[131] In principle, where there is no question of evasion of the statutory controls, this approach seems as applicable to duty defining clauses as to exemption clauses. There is thus perceived to be less justification for a very strict approach to construction.

3.3.17 However, the basic contra proferentem approach remains and it is unlikely that words held to have one meaning before the enactment of UCTA will now be held to have a different meaning or that a radically different approach will be used.[132] In the context of fiduciary duties, we have noted that it is not possible to exclude liability for fraud, deliberate breach of duty, and possibly gross negligence. Although it is our provisional view that, apart from this, there is no common law prohibition on exclusions, clauses attempting to modify the normal incidents of a particular fiduciary relationship are likely to be construed strictly.[133]

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[128] *Canada SS Lines Ltd.* v. *The King* [1952] A.C. 192; *Lamport & Holt Lines Ltd.* v. *Coubro & Scrutton (M. & I.) Ltd.* [1982] 2 Lloyd's Rep. 42.

[129] Clause 30 of the IFMA and BMBA Terms and Conditions for Discretionary Fund Management, (Edition IFMA/BMBA 2, 1991) serves as an exemplar for this kind of clause.

[130] Para. 3.3.14, above.

[131] *Photo Production Ltd.* v. *Securicor Transport Ltd.* [1980] A.C. 827, 843, *per* Lord Wilberforce.

[132] See, for example, *Ailsa Craig Fishing Co. Ltd.* v. *Malvern Fishing Co. Ltd.* [1983] 1 W.L.R. 964, 966, 969-970.

3.3.18 We have noted that the regulatory rules will be part of the factual matrix against which the contract will be construed.[134] In the context of financial services it is therefore relevant to consider the Core Rules and the third tier rules. For instance, some of the Core Rules, such as those on customer order priority, best execution, and timely allocation, are formulated in terms which do not envisage exclusion or disapplication.[135] Furthermore, Core Rule 15, which is discussed below,[136] prohibits the exclusion of duties owed under the FSA or the regulatory system. This is likely to affect the approach of the court to the construction of the contract. A court would be reluctant to construe a term as excluding contractual liability where there is liability under the regulatory system, particularly as Core Rule 15(1)[137] prohibits a firm from seeking "to exclude or restrict any duty or liability to a customer which it has under the [FSA], or under the regulatory system".[138] It is likely that it would construe the term so as not to conflict with the regulatory rule even where the rule is not incorporated into the contract as a trade practice.[139] Where it is so incorporated, it is likely that it will override the exemption clause.[140]

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[133] See, for example, *Richmond Ltd.* v. *DHL International (NZ) Ltd.* (1991) 3 N.Z.B.L.C. 118, 125-6.

[134] Para. 3.3.3, above.

[135] Core Rules 20, 22 and 23, set out in Appendix 3. Other Core Rules do envisage modification, for instance, the duty to segregate client money belonging to a professional investor: see Blair, *Financial Services: The New Core Rules* (1991), at 91-92.

[136] Para. 3.3.26, below.

[137] SFA rule 5-24.

[138] See further para. 3.3.26, below.

[139] As to which see paras. 3.2.8-3.2.12, above.

[140] See Treitel, *op. cit.*, at 223-224.

3.3.19 Turning to the types of clauses commonly encountered in the contexts with which we are concerned, clauses excluding the "no conflict" or the "no profit" rules or permitting an intermediary to act on his own account without further notice are likely to be construed strictly. For instance, clauses excluding liability for "potential conflicts" will not exclude liability for actual conflicts. Where the clause takes the form of a duty defining clause, such as clause 30 of the IFMA and BMBA standard conditions for discretionary fund management,[141] it is possible that a less strict approach will be taken.

3.3.20 The degree of strictness will depend on a number of factors including the relative positions of the parties and the question of whether it would be possible for further disclosure to be made before an individual transaction. For instance, a clause stating that the firm is not obliged to disclose to the customer any information the disclosure of which by it would or might be a breach of duty or confidence to any other person[142] is likely to receive a less hostile construction than a clause stating that the firm is not obliged to take into consideration such information which has not come to the actual notice of the individual making the recommendation. In the latter situation a difference might be perceived between information which the individual making the recommendation could not on any view have known, perhaps because of the operation of an established Chinese wall, and information of which he might have known but which was not passed to him, for instance, by others in his department. Here it will be material to know whether the firm's failure to pass the information to the individual constituted negligence. In this connection the rule on the construction of exemption clauses as regards negligence should be borne in mind.[143]

3.3.21 A second example concerns clauses which provide that the firm may effect transactions for the customer in which it has a material interest or specified types of potential conflicts of interest or of duty and that it shall not be liable to account for any profit, commission, or remuneration received by reason of such transactions.[144] These clauses are likely to be strictly construed. The issue of what constitutes adequate disclosure is considered in detail in Section 3.4, below. However, it is likely that the more general the description of the material interest or potential conflict, the less likely it is to cover a conflict which has actually arisen. This difficulty might be met by a list of types of conflicts,[145] for instance that the firm's directors are directors or shareholders in, or that the firm has provided underwriting services to, a company which is the subject of a recommendation, especially where it is not possible to make particular disclosure in advance of each relevant transaction. However, where at the time the contract is entered into the firm is aware of a material interest or an actual conflict of interest but makes no further disclosure, unless disclosure would constitute breach of duty to a third party,[146] it is unlikely that such a clause will suffice to exonerate it from liability.[147]

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[141] Edition IFMA/BMBA 2, 1991; see para. 2.2.7, above.

[142] Clause 31 of the IFMA and BMBA Terms and Conditions for Discretionary Fund Management (Edition IFMA/BMBA2, 1991) serves as an exemplar for this type of clause.

[143] See para. 3.3.15, above.

3.3.22 Finally, an effective exclusion of fiduciary duty can be rendered ineffective by a subsequent course of dealings between the parties, for example where an execution only customer whose relationship with the broker/dealer was that of principal in respect of decisions as to which securities to purchase and at what price, starts to take and rely on the broker/dealer's advice in this regard. It is clear that a fiduciary relationship is not exclusively circumscribed by the agreement between the parties,[148] and can develop in the course of dealings between parties.[149] Thus, in the situation posed it would seem that a different and higher level of fiduciary relationship would evolve on top of the old, and the initial exclusion of duties or definition of the relationship at its previous lower level would be superseded.

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[144] Clause 20, of the IFMA and BMBA Terms and Conditions for Discretionary Fund Management (above, n. 142) serves as an exemplar for this kind of clause.

[145] Clause 20, *ibid.*, gives 13 examples of situations in which there may be "potential conflicting interests or duties".

[146] Even then it may not be sufficient; see para. 3.4.13 below.

[147] Cf. the analogy of *Re Banister* (1879) 12 Ch. 131, 136, 142-143, 149 and the discussion of fraud and deliberate breach of duty above.

[148] See, for example, *Demerara Bauxite Company Limited* v. *Louisa Hubbard* [1923] A.C. 673, 675-6 (fiduciary obligations of solicitor may continue after the termination of the solicitor/client relationship) and Powell, *The Law of Agency* (2nd ed., 1961), at 314.

[149] See also para. 3.1.2, above.

3.3.23 Where a clause is held not to cover the conduct under consideration it obviously cannot be used to exempt or limit liability for breach of fiduciary duty. Where, on the courts' approach to construction, a clause is held to cover the conduct, prima facie it will be effective except to the extent that it seeks to exclude liability for conduct which, at common law, a fiduciary may not exclude and unless it is subject to statutory control. The next section deals with statutory control.

Statutory Control - UCTA

3.3.24 UCTA imposes two types of control over clauses in certain standard form contracts and contracts with consumers which exclude or restrict liability.[150] It either prohibits them or subjects them to a reasonableness test. Before examining the statutory controls, it is necessary to consider to which contracts UCTA applies. Schedule 1 provides that the controls with which we are concerned[151] do not apply to any contract of insurance,[152] nor to any contract "so far as it relates to the creation or transfer of securities or any right or interest in securities".[153]

3.3.25 In the context of the provision of financial services this removes entirely from the scope of UCTA any contract of insurance and contracts *relating to* securities. "Securities" is not defined for the purposes of UCTA.[154] We are only aware of one decision on the scope of the securities exception.[155] In that case it was emphasised that the exception applies to "*any contract so far as* it relates to the creation or transfer of securities", as opposed merely to contracts for the creation or transfer of securities. The exception could thus apply to a provision in a contract of employment relating to a share option scheme. However, it seems clear that contractual provisions regarding the giving of advice on securities - including discretionary fund management - will not be exempted from UCTA. On the other hand, we believe that a clause which purports to exclude liability to disclose or to account for the profit made from another customer where transactions are matched, or which excludes the duty to provide best execution in a genuine execution-only contract between market counterparts, may well fall within the exemption and thus not be subject to UCTA. We also believe it likely that clauses concerning the disclosure of self dealing in a prospectus issued by the manager of a unit trust scheme would be exempt from review under UCTA. However, similar clauses in contracts with broker/dealers or in management agreements are likely to be held to be subject to UCTA so far as they relate to the giving of advice.

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[150] UCTA, s. 13.

[151] Sections 2 and 3; see para. 3.3.27, below.

[152] Para. 1(a).

[153] Para. 1(e).

3.3.26 The situation is complicated by the fact that Core Rule 15[156] restricts the ability of a firm to exclude or restrict liability and, in effect, seeks to accord customers protection, in some cases similar to, and in others greater than that under UCTA.[157] Core Rule 15(1), which has been mentioned,[158] prohibits the exclusion or restriction of any duty or liability to a customer which is owed under the FSA or under the regulatory system. Core Rule 15(3) states that a firm "must not seek unreasonably to rely on any provision seeking to exclude or restrict any such duty". These Rules apply to all customers and Rule 15(2) provides an additional layer of protection to private customers. It prohibits the exclusion or restriction of any other duty to act with skill, care and diligence or any liability for failure to exercise the degree of skill, care and diligence which may reasonably be expected of the firm in the provision of investment services. These provisions have been said to be designed to be consistent with the controls in UCTA and to fill the gap left in UCTA by the provision disapplying it to contracts relating to securities.[159] It is, however, not clear what their legal effect is. While they may (a) affect the court's approach to the construction of the contract, (b) be incorporated into the contract as a trade practice,[160] (c) be relevant to the operation of the reasonableness test where UCTA applies to a transaction, or (d) constitute an inhibition on exclusion clauses imposed by secondary legislation, they cannot obviously bring into the scope of UCTA contracts expressly excluded.[161] If, however, they are taken into account in the construction of a contract or are incorporated into it, the result is likely to be the same in practice.

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[154] Cf. the definition in the Company Securities (Insider Dealing) Act 1985, s. 12(a). See also FSA, Sch. 1, paras. 1-3.

[155] *Micklefield* v. *SAC Technology Ltd.* [1991] 1 All E.R. 275, 281.

[156] Set out in Appendix 3.

[157] Compare the absolute prohibition in Core Rule 15(1), below, of exclusion of duties under the FSA or the regulatory system with the subjection of written terms of business to a reasonableness test by UCTA, s. 3, on which see below.

[158] Para. 3.3.18, above.

3.3.27 We are concerned with sections 2(2) and 3 of UCTA which relate to exclusions of liability arising in contract[162] and from negligence falling short of death or personal injury.[163] These apply only to "business liability".[164] This test will be satisfied in the circumstances we are considering where the fiduciary will always be acting in the course of business, whether the provision of financial, legal, estate agency, or other services.

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[159] Blair, *op. cit.*, at 92.

[160] See Section 3.2, above, subject to the express terms of the contract, as to which, see para. 3.2.2 and n. 7, above.

[161] Even the public law approach to regulation, considered in Part V, is unlikely to sanction the direct contradiction of the terms of a statute.

[162] S. 3; see para. 3.3.31, below.

[163] S. 2(2); see para. 3.3.29, below.

[164] This is defined in s. 1(3).

3.3.28 Most of the relevant sections of UCTA apply to terms which purport to "exclude or restrict" liability[165] although the statute also applies to clauses purporting to exclude the duty of care giving rise to liability in negligence and duties which would arise out of implied terms in the supply of goods.[166] This raises the difficult question as to how UCTA applies to duty defining clauses which seek to prevent duties from arising ab initio by defining the scope of the contractual undertaking,[167] and disclosure clauses which seek to negative duties in specified circumstances.[168] Some authorities accept that certain clauses define the rights and duties of the parties rather than exempting one of them from liability.[169] However, in recent decisions the courts have been unwilling to accept arguments that clauses shrink the core of the duty of a party and thus avoid the application of UCTA.[170] These cases, which concerned liability for negligence, indicate that, where the substance of a provision is to negative a duty which would otherwise fall on a firm, it is likely to be treated as excluding liability. In principle, given the non-contractual aspects of fiduciary duties, the same approach appears appropriate. If this is so, in classic fiduciary relationships which are subject to the full range of duties, clauses which state that a firm may act despite a material interest or a conflict of duties or which provide for less than full disclosure are likely to be treated as exclusion clauses. In other situations which are less easy to characterise as fiduciary or as subject to a particular duty, the position may differ. However, we shall see that UCTA's structure may indicate that a different approach should be taken to clauses seeking to avoid section 3 which deals with strict liability from that taken to clauses seeking to avoid section 2 which deals with liability for negligence.

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[165] Ss. 2(2), 3(2)(a).

[166] S. 13(1). This extended definition does not apply to clauses which fall within s. 3, although s. 3(2)(b) does cover attempts to render substantially different performance from that reasonably expected.

[167] For example, clauses which state that the relationship between the parties is not one of agency, does not give rise to fiduciary duties, or is exclusively defined by the agreement.

[168] For example, clauses in advisory and dealing services agreements which state that the company could be dealing as principal or matching the customer's transaction with that of another customer.

[169] For example, *G.H. Renton & Co. Ltd.* v. *Palmyra Trading Corpn. of Panama* [1957] A.C. 149; *The Angelia* [1973] 1 W.L.R. 210.

[170] *Phillips Products Ltd.* v. *Hyland* [1987] 1 W.L.R. 659 (Note); *Harris* v. *Wyre Forest District Council, Smith* v. *Eric S. Bush* [1990] 1 A.C. 831. Cf. *Thompson* v. *T. Lohan (Plant Hire) Ltd.* [1987] 1 W.L.R. 649; *McGrath* v. *Shah* (1989) 57 P. & C.R. 452.

3.3.29 Provisions in any contract term or notice[171] which exclude or restrict liability for negligence, or exclude the duty giving rise to liability in negligence,[172] resulting in loss or injury short of death or personal injury are subject to section 2(2) of UCTA. "Negligence" includes contractual and common law duties to take reasonable care or exercise reasonable skill.[173] Section 2(2) will not affect clauses which exclude liability for breach of fiduciary duty exceeding this level of care.

3.3.30 The statute applies where one contracting party deals as consumer[174] or on the other's written standard terms of business, as will usually be the case in financial services business, where most parties contract on standard terms.[175] However, it seems that it will not apply to trust instruments in the light of the rejection of the contractual analysis of the right of a trustee to remuneration under an express charging clause in the trust instrument,[176] in *Re Duke of Norfolk's Settlement Trusts*.[177] That case did not, however, concern the original parties to the settlement. In the context of a professional trustee and an agreement between the original settlor and the trustee there is a stronger case for regarding the relationship as contractual, but there might be difficulties in applying UCTA only between those parties.

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[171] For definition see s. 14.

[172] S. 13(1); see nn. 166,167, above.

[173] S. 1(1)(a),(b).

[174] For the definition of "deals as consumer" see s. 12.

[175] S. 3.

[176] See also para. 3.3.10, n.89, above.

[177] [1982] Ch. 61, 76-7.

3.3.31 Section 3 affects provisions whereby one party to the contract seeks as against the other to:

> "(a) when himself in breach of contract, exclude or restrict any liability of his in respect of the breach; or
>
> (b) claim to be entitled-
>
> (i) to render a contractual performance substantially different from that which was reasonably expected of him, or
>
> (ii) in respect of the whole or any part of his contractual obligation, to render no performance at all."

Sub-paragraph (b) is not restricted to clauses which exclude or limit liability and appears to apply to some permissive clauses such as, for example, a clause in a broker/dealer's contract which purports to allow him, although an agent, to act as principal or sell off his own book, provided the customer had a reasonable expectation that the broker/dealer would in fact be acting as agent. This is a form of duty defining clause and it seems that sub-paragraph (b) attempts to bring these permissive clauses within the statute although it is doubtful how far it has succeeded in bringing in all duty defining clauses.[178] Since the extended definition of "exclude or restricts liability" in section 13 does not apply to section 3, the anti-avoidance approach which has been used in the context of section 2, i.e. liability for negligence, may not be appropriate.

3.3.32 Where a term falls within section 2(2) or section 3 it will be invalid in so far as it does not satisfy the "requirement of reasonableness". The burden of proving that a term is reasonable lies on the party seeking to rely on it.[179] Reasonableness is assessed in the light of "the circumstances which were, or ought reasonably to have been, known to or in the contemplation of the parties *when the contract was made.*"[180] This means that in the above example[181] it would be necessary to assess whether it was reasonable for the broker/dealer to provide that it might deal off its own book by reference to the circumstances existing at the time the contract was made, rather than at the time the relevant sale was executed.

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[178] See the cases and commentators cited above. See further, Treitel, *op. cit.* at 323; Palmer & Yates, "The Future of the Unfair Contract Terms Act 1977", [1981] C.L.J. 108, 123 ff.

[179] S. 11(5).

3.3.33 Decisions on what is reasonable are likely to be made on a case by case basis.[182] It has been stated that decisions of trial courts on whether a clause is reasonable are analogous to exercises of discretion, that the courts must entertain a wide range of considerations, and that there will be room for a legitimate difference of judicial opinion as to the correct answer.[183] However, subject to this, it would appear that the following factors will be relevant in the contexts we are considering:

(i) whether the person relying on the clause has been negligent,[184]

(ii) the clarity of the clause,[185]

(iii) the relative bargaining strengths of the parties,[186]

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[180] S. 11(1) (emphasis added). Note that the statutory guidelines as to reasonableness in Sch. 2 do not apply for the purposes of ss. 2 & 3.

[181] Para. 3.3.31, above.

[182] See, for example, *George Mitchell (Chesterhall) Ltd.* v. *Finney Lock Seeds Ltd.* [1983] 2 A.C. 803, 810; *Smith* v. *Eric S. Bush* [1990] 1 A.C. 831, 858.

[183] *George Mitchell (Chesterhall) Ltd.* v. *Finney Lock Seeds Ltd.*, *ibid.*, at 816, *per* Lord Bridge.

[184] *George Mitchell (Chesterhall Ltd.* v. *Finney Lock Seeds Ltd.*, *ibid.*, at 817. See also *Walker* v. *Boyle* [1982] 1 W.L.R. 495;

[185] *George Mitchell (Chesterhall) Ltd.* v. *Finney Lock Seeds Ltd.* [1983] Q.B. 284, 314; [1983] 2 A.C. 803, 816; *Stag Line Ltd.* v. *Tyne Shiprepair Group Ltd.* [1984] 2 Lloyd's Rep. 211, 222.

[186] *Photo Production Ltd. v. Securicor Transport Ltd.* [1980] A.C. 827; *Scandanavia Trading Tanker Co. A.B.* v. *Flota Petrolera Ecuatoriana* [1983] 2 A.C. 694, 703-704.

(iv) whether the clause was imposed by one side, was the product of negotiations between representative bodies, or had evolved over time as a result of trade practice,[187]

(v) whether the person against whom the clause was being invoked had been given an opportunity of dealing on alternative terms and had received an inducement (for instance a reduced price for the service) to agree to the term,[188]

(vi) whether the *proferens* or others who used the clause had sought to rely on it in the past.[189] Although the *George Mitchell* case, in which this was considered, concerned the reasonableness test in the Supply of Goods (Implied Terms) Act 1973 (consolidated in the Sale of Goods Act 1979) which required the Court to consider the reasonableness of *reliance* on the term and not whether, as is required by UCTA, it is reasonable to incorporate it, it is arguable that it may be unreasonable and misleading to incorporate a term which is not relied upon in a trade,

(vii) whether the person seeking to rely on the clause could insure at all or without significantly affecting the cost of the services provided,[190]

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[187] See the reasoning in *Walker* v. *Boyle* [1982] 1 W.L.R. 495; *George Mitchell (Chesterhall) Ltd.* v. *Finney Lock Seeds Ltd.* [1983] Q.B. 284, 307, 313. See also n. 194, below.

[188] *George Mitchell (Chesterhall) Ltd.* v. *Finney Lock Seeds Ltd.* [1983] 2 A.C. 803, 817; *Woodman* v. *Photo Trade Processing* (1981) 131 N.L.J. 933. See also Sch. 2, para. (b) albeit only in relation to sales of goods; Cheshire, Fifoot and Furmston, *op. cit.*, at 187-188.

[189] *George Mitchell (Chesterhall) Ltd.* v. *Finney Lock Seeds Ltd.* [1983] Q.B. 284, 302, 313; [1983] 2 A.C. 803, 817.

[190] *George Mitchell (Chesterhall) Ltd.* v. *Finney Lock Seeds Ltd.* [1983] Q.B. 284, 302, 307, 313; [1983] 2 A.C. 803, 817; *Smith* v. *Eric S. Bush* [1990] 1 A.C. 831, 859. See Cheshire Fifoot and Furmston, *op. cit.*, at 190-191.

(viii) the magnitude of the damage in relation to the price charged for the service.[191]

3.3.34 In the context of our inquiry, factor (iv) is particularly worthy of comment. The fact that the regulatory rules permit the modification of the underlying duty is likely to be a factor pointing towards reasonableness. Examples of this include Core Rule 18(2) permitting the disclosure of the basis or nature of remuneration, Core Rule 36 preventing the automatic attribution of knowledge between different parts of one entity separated by a Chinese wall,[192] and the ability of a firm dealing with a professional customer to derogate from the duty to segregate customer money.[193]

3.3.35 However, trade practice imposed by one side is not likely to be a weighty factor and the fact that a term has been generally accepted does not mean that it will be found reasonable.[194] Thus, the fact that an exemption clause reflects a SRO rule will not make it immune to challenge under UCTA and, as a matter of policy, it would be difficult to justify such a removal or even a dilution of the protection provided by UCTA. It is not clear whether terms reflecting SRO rules will be treated as imposed by one of the parties. The statutory requirement[195] that the governing body of a recognised SRO must secure a proper balance between the interests of members and those of the public suggests that they may not be so treated. By contrast, where regulatory rules in fact embody the substance of common law or equitable obligations, as in the case of Core Rules 20 to 27,[196] an attempt to exclude the common law or equitable duties is unlikely to be held to be reasonable. This is particularly so since Core Rule 15 prohibits such exclusion or restriction of liability.[197]

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[191] The effect of this factor is unclear. Two of those in *George Mitchell* who mentioned it (Lord Denning and Lord Bridge) considered that where the price is small but the damages very large this was a factor which favoured a finding of reasonableness but Kerr L.J. appeared to take a different view.

[192] See para. 4.5.12, below. These rules are set out in Appendix 3.

[193] The Financial Services (Client Money) Regulations 1991, r. 2.02.3

[194] *George Mitchell (Chesterhall) Ltd.* v. *Finney Lock Seeds Ltd.* [1983] 2 A.C. 803 (limitation clause which was a standard term of trade but which had not been negotiated by the representative bodies of the different parties found unreasonable). See also *Walker* v. *Boyle* [1982] 1 W.L.R. 495; *Warren* v. *Mendy* [1989] 1 W.L.R. 853; *Watson* v. *Prager* [1991] 1 W.L.R. 726.

[195] FSA, Sch. 2 para. 5.

3.3.36 Bearing in mind that the fluidity of the test makes it difficult to make any predictions, we shall now consider some of the standard clauses which seek to resolve what would otherwise be direct or implicit conflicts[198] between regulatory rules and fiduciary duties. We have already considered possible approaches to the construction of such clauses[199] and the factors mentioned in that context will also be relevant to the application of the "reasonableness" test.

3.3.37 There are several factors suggesting that, where there is a duty of best execution, a term permitting a broker/dealer to self-deal or carry out an agency cross would be held reasonable. The customer will suffer no real prejudice as the obligation to obtain the best price is retained and the commercial realities of the market are such that it is often impossible for the broker/dealer to know in advance whether he will be acting as an agent, or whether the transaction will be matched. In very illiquid markets a securities house may be the only market-maker in a particular stock, and it will not necessarily be in the customer's best interests[200] to refer him elsewhere merely to avoid self-dealing. Similarly, a clause which allows a firm to withhold confidential information acquired from one customer from another may be reasonable, given the firm's duties to other customers, i.e. the legal constraints on the right of a fiduciary to release information, the prohibition on insider dealing, the fact that conflicts regarding confidential information are inevitable in multi-function financial conglomerates and cannot be avoided without radically restructuring the market, and SIB Core Rule 36.[201]

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[196] These are set out in Appendix 3. They impose duties concerning (i) fairness and timeliness in connection with customer order priority (20), execution of orders (21), allocation of transactions (23 and 24), (ii) best execution (22), (iii) "front-running" (26) and, (iv) derivatives transactions (27).

[197] See paras. 3.3.18 and 3.3.26, above.

[198] Implicit conflicts may arise in situations where, although regulations do not explicitly seek to legitimise a practice, they are framed on the assumption that it is. See, for instance, limited disclosure on commission (Core Rule 18(2)) and the rules assumptions about the efficacy of general consent in advance provisions in customer agreements, see further paras. 5.3.13-5.3.15 and 5.3.11, below.

[199] See paras. 3.3.19-3.3.21, above.

[200] For example, if the house has particular expertise in that stock. See further, para. 2.2.8(i), n.15, above.

3.3.38 UCTA provides that terms subject to the reasonableness requirement are ineffective "except insofar as" they satisfy it.[202] Although this makes it possible for a court to hold a provision partly valid and partly invalid in a case where it is possible to sever the clause, it would not, for instance, permit partial invalidation of a total exclusion.[203] For this reason it is likely to be imprudent to have wide clauses where a partial exemption would be more likely to be reasonable. However, even a non-severable term which seeks to exclude several different types of liability may not be rendered completely ineffective, but may be operative in respect of a liability which does not fall within the scope of UCTA. For example a clause which excludes liability both in relation to the provision of advice on the purchase of securities and their actual purchase, would be ineffective so far as the former is concerned but effective (subject to common law and equitable restrictions)[204] as regards the latter.

Provisional Conclusion

3.3.39 The extent to which it is possible to modify or exclude fiduciary duties by the terms of a contract or other instrument cannot be stated with precision. Where a de facto fiduciary relationship existed between the parties prior to the time when the contract was made, it will be harder to exclude duties in the absence of full disclosure, possibly independent advice, and the court being satisfied about the overall fairness of the transaction. Where no such relationship existed, the approach of the court may depend on the type of exclusion clause used and the extent to which it regards the relationship as one of status rather than contract. Where a duty defining clause is used there is some doubt as to whether it will be treated as defining the terms of the relationship, or whether the court will look to the core of the relationship and strike down the clause if it is inimical to this, for example, if it purports to allow a fiduciary to act as principal rather than agent. We have provisionally concluded that, in such cases, the court should have regard to all the terms of the contract or instrument when determining whether the relationship is fiduciary and, if so, the scope of the fiduciary's duties.[205]

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[201] Set out in Appendix 3.

[202] Ss. 2(2), 3(2), 4(1) and 7(4). See also ss. 6(3) and 7(3) effective "only insofar as" reasonable.

[203] *George Mitchell (Chesterhall) Ltd.* v. *Finney Lock Seeds* [1985] 2 A.C. 803, 816, *per* Lord Bridge; Treitel, *op. cit.*, at 235-236.

[204] As to which, see paras. 3.3.4-3.3.23, above and Section 3.4, below (disclosure).

3.3.40 Trustees and other fiduciaries may exclude or modify the no-conflict and the no-profit rules if they do so clearly and make full disclosure.[206] The common law rules on exclusion clauses generally will not affect a clearly worded clause, but a clause subject to UCTA (in the financial services area primarily those in standard term contracts relating to the provision of advice), will be subject to challenge if it is not reasonable. As we have seen, there is uncertainty as to when a clause will be found reasonable and the role of regulatory rules in the operation of the reasonableness test.

3.3.41 Beyond this, trustees and fiduciaries cannot exempt themselves from liability for fraud, bad faith and wilful default. It is not, however, clear whether the prohibition on exclusion of liability for 'fraud' in this context only prohibits the exclusion of common law fraud or extends to the much broader doctrine of equitable fraud. It is also not altogether clear whether the prohibition on the exclusion of liability for 'wilful default' also prohibits exclusion of liability for gross negligence although we incline to the view that it does.

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[205] See paras. 3.3.11-3.3.12, above.

[206] On what constitutes full disclosure, see Section 3.4 below.

3.3.42 Quite apart from these uncertainties, however watertight an exclusion clause may be, it will not prevent the introduction of new duties into the relationship as it develops over time. Exclusion clauses cannot, in our view, always in this situation be relied on as a means of modifying fiduciary duties under the general law so as to avoid conflicts between those duties and duties imposed by the regulatory rules.

3.4 Disclosure and Consent

3.4.1 The rule of equity that prohibits a fiduciary from putting himself in a position where his duty and interest or duties to two or more beneficiaries conflict is not absolute. It applies "unless otherwise expressly provided",[207] for example, by authorisation in the trust instrument, or other document constituting the relationship.[208] The consent of the person(s) to whom the duty is owed,[209] obtained after the making of full disclosure, precludes an action for breach of duty.[210] The extent to which the fiduciary duties are modified depends on the extent of the disclosure and what the beneficiary has consented to.

3.4.2 The responses to the Issues Questionnaire revealed that most practitioners in the financial services industry place considerable reliance on generalised advance disclosures which they incorporate in their customer agreements. These may provide, for example, that the firm may have a material interest in a transaction and give examples of the types of interest which might arise.[211] Disclosure is also made on, for example, contract notes and research publications where required by regulatory rules.[212] In this section we shall consider the relationship between disclosure and exclusion clauses, what must be disclosed in order to obtain sufficiently informed consent, when disclosure must be made, what form it must take, and whether there are any circumstances in which full disclosure is ineffective.

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[207] *Bray* v. *Ford* [1896] A.C. 44, 51, *per* Lord Herschell. See also *Aberdeen Railway* v. *Blaikie Bros.* (1854) 1 Macq. 461, 471; *Regal (Hastings) Ltd.* v. *Gulliver (Note)* [1967] 2 A.C. 134.

[208] For example, *Re Sykes* [1909] 2 Ch. 241; *Re Llewellin's Will Trusts* [1949] Ch. 225; *Boulting* v. *Association of Cinematograph, Television, and Allied Technicians* [1963] 2 Q.B. 606, 636.

[209] Provided they are of full age and sui juris, (*Boulting* v. *Association of Cinematograph, Television and Allied Technicians*, above, at 636.) Where the fiduciary is a trustee purchasing trust property, the consent of all the beneficiaries is required, (*Ex p. Lacey* (1802) 6 Ves. Jun. 625, 627. See further, Goff & Jones, *The Law of Restitution* (3rd ed., 1986), at 638). Where it is an agent acting on behalf of a trust it is not clear whether consent of all the trustees will suffice, or whether the consent of all the beneficiaries is required, (*Boardman* v. *Phipps* [1967] 2 A.C. 46. See further Hanbury and Maudsley, *Modern Equity* (13th ed., 1989), at 574-5).

[210] For example, *Dunne* v. *English* (1874) L.R. 18 Eq. 524; *Parker* v. *McKenna* (1874) L.R. 10 Ch. App. 96, 118; *Fullwood* v. *Hurley* [1928] 1 K.B. 498; *Boardman* v. *Phipps* [1967] 2 A.C. 46; *North and South Trust Co.* v. *Berkeley* [1971] 1 W.L.R. 470.

Is a Disclosure Clause an Exclusion Clause?

3.4.3 The dividing line between a generalised disclosure clause and an exclusion clause may be thin. For example, a clause which states that a fiduciary may act as agent or principal may be interpreted as defining the fiduciary's duties, excluding liability for breach of duty in the event that he should act as principal, or disclosing that he sometimes acts as principal. The approach adopted by a court to such a clause may be important. The tests by which the effectiveness of exclusion and disclosure clauses are respectively assessed are not the same. "Full" disclosure[213] is required unless a trade custom[214] permits a lesser level. However, if UCTA does not apply, an exclusion clause need only be "clear".[215] Even if an exclusion clause is subject to UCTA, it need only be "reasonable".[216] Although the fullness of the disclosure might be taken into account in assessing reasonableness, it will not be determinative. It is thus possible that a clause which does not make sufficiently full disclosure to preclude an action for breach of fiduciary duty on the grounds of informed consent could provide a defence as an effective exclusion clause. Where less than full disclosure suffices as a matter of custom,[217] it is possible that a clause making adequate disclosure could, if subject to UCTA,[218] be rendered ineffective as an unreasonable exclusion clause.

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[211] See, for example, clause 20 of the IFMA and BMBA Terms and Conditions For Discretionary Fund Management, (Edition IFMA/BMBA2, 1991).

[212] For example SFA Rules 5-34 and 5-36.

[213] See para. 3.4.4, below.

[214] See Section 3.2, above and paras. 3.4.7-3.4.10, below.

[215] See paras. 3.3.14-3.3.15, above.

[216] See paras 3.3.32-3.3.33, above.

Content of Disclosure

3.4.4 We will now consider what must be disclosed in order to obtain consent which is sufficiently informed to operate as a defence to an allegation of breach of fiduciary duty. As a general rule, full disclosure must be made of all material facts, it being insufficient merely to disclose that the fiduciary has an interest or put the beneficiary on enquiry.[219] This necessitates disclosure of the full nature and extent of the fiduciary's interest.[220] For example, where a fiduciary proposes to sell his property to the beneficiary he must disclose his interest as vendor, and (subject to the exception mentioned below in relation to brokers) if the property was purchased recently, the price at which it was acquired and any profit resulting from the sale.[221] Any facts which might affect the beneficiary's decision whether or not to proceed must also be disclosed.[222] This may include any effect which the fiduciary's interest will have on the beneficiary's legal rights.[223] It is not sufficient to make partial disclosure.[224] However, it is not necessary to disclose a fact which the beneficiary already knows, "or would have known ... if he had thought about it".[225] The onus of proving that adequate disclosure has been made rests on the fiduciary.[226] It is no defence to show that a legal or financial impediment on the part of the beneficiary would have prevented him from proceeding with the relevant transaction,[227] or that disclosure would not have affected the beneficiary's decision whether to proceed.[228]

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[217] See Section 3.2, above and paras. 3.4.7-3.4.10, below.

[218] See para 3.3.35, above.

[219] For example, *Dunne* v. *English* (1874) L.R. 18 Eq. 524 at 533; *New Zealand Netherlands Society 'Oranje' Incorporated* v. *Kuys* [1973] 1 W.L.R. 1126 at 1131-1132; *Tufton* v. *Sperni* [1952] 2 T.L.R. 516; *Tate* v. *Williamson* (1866) L.R. 1 Eq. 528, 536-7; *Demerara Bauxite Co* v. *Hubbard* [1923] A.C. 673.

[220] See, for example, *Rothschild* v. *Brookman* (1831) 2 Dow & Cl. 188; *Bagnall* v. *Carlton* (1877) 6 Ch. 371; *Liquidators of Imperial Mercantile Credit Association* v. *Coleman and Knight* (1873) 6 L.R. H.L. 189; *Emma Silver Mining Co.* v. *Grant* (1879) 11 Ch. 918; *Gluckstein* v. *Barnes* [1900] A.C. 240; *Bartram and Sons* v. *Lloyd* (1904) 90 L.T.R. 357.

[221] *Driscoll* v. *Bromley* (1837) 1 Jur. 238; *Kuhlirz* v. *Lambert Brothers Limited* (1913) 108 L.T. 565, 568. Cf. *Regier* v. *Campbell-Stuart* [1939] Ch. 766 in which Farwell J. suggested that, where an agent intends to sell to his principal, provided that he acts honestly and faithfully and does not conceal material facts, such as that he bought property for himself with a view to selling on to his principal at a profit, it is sufficient for him to disclose that the property belongs to him and he is intending to act as vendor. See also *Chesterfield and Boythorpe Colliery Company* v. *Black* (1878) 37 L.T. 740.

[222] *New Zealand Netherlands Society 'Oranje' Incorporated* v. *Kuys* [1973] 1 W.L.R. 1126, 1131-2. See also *Moody* v. *Cox and Hatt* [1917] 2 Ch 71, 80; *Demerara Bauxite* v. *Hubbard* [1923] A.C. 673, 689. Cf. *McMaster* v. *Byrne* [1952] 1 All E.R. 1362, 1367, where the Privy Council said that the proper test for assessing the necessity for disclosure was not by reference to the reaction of the

3.4.5 It is impossible to lay down a precise test against which the adequacy of disclosure can be assessed. Much will depend on the particular circumstances, for example, the knowledge and expertise of the customer. A lower level of disclosure may suffice where the customer is experienced and, for example, familiar with transactions on the relevant market.[229] The capacity in which the fiduciary is acting may also be of relevance. The disclosure obligation on an adviser is particularly onerous. Taking the example of an adviser purchasing trust property, he must, in addition to disclosing his intention to purchase, the price

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particular individual to whom the disclosure should have been made, but to "the natural reaction of the reasonable man".

[223] See, for example, *Boulting* v. *Association of Cinematograph, Television and Allied Technicians* [1963] 2 Q.B. 606, 636.

[224] *Bartram and Sons* v. *Lloyd* (1904) 90 L.T. 357; *Gluckstein* v. *Barnes* [1900] A.C. 240; *Peek* v. *Gurney* (1873) L.R. 6 H.L. 377; *Arkwright* v. *Newbold* (1881) 17 Ch.D. 301, 318.

[225] *Anangel Atlas Compania Naviera S.A.* v. *Ishikawajima-Harima Heavy Industries Co. Ltd.* [1990] 1 Lloyd's Rep 167, 171. See also *Mouat* v. *Clark Boyce* [1991] 1 NZ Conv C 190,917 at 190,939.

[226] See, for example, *Rothschild* v. *Brookman* (1831) 2 Dow & Cl. 188; *Dunne* v. *English*, above; *Williams* v. *Scott* [1900] A.C. 499, 508.

[227] *Boardman* v. *Phipps* [1967] 2 A.C. 46; *Regal (Hastings) Ltd.* v. *Gulliver (Note)* [1967] 2 A.C. 134.

[228] *Brickenden* v. *London Loan and Savings* [1934] 3 D.L.R. 465, 469 (P.C.); *Glennie* v. *McDougall & Cowan Holdings Ltd.* [1935] 2 D.L.R. 561, 579; *Farrington* v. *Rowe Mcbride & Partners* [1985] 1 N.Z.L.R. 83, 93; *Estate Realties Ltd.* v. *Wignall* [1991] 3 N.Z.L.R. 482. Cf. *New Zealand Netherlands Society 'Oranjie' Incorporated* v. *Kuys and Another*, above, 1131-2; *Walden Properties Ltd.* v. *Beaver Properties Pty. Ltd.* [1973] 2 N.S.W.L.R. 815, 847.

[229] For example, *Sachs* v. *Spielmann* (1889) 5 T.L.R. 487, 488; *Lord Norreys* v. *Hodgson* (1897) 13 T.L.R. 421, 422; *Baring* v. *Stanton* (1876) 3 Ch. 502, 505; *Stubbs* v. *Slater* [1910] 1 Ch. 632, 642, 648.

which he will pay, and any other information which he has about its value, give "... all that reasonable advice against himself, that he would have given ... against a third person."[230] Where the fiduciary is a solicitor or trustee the obligation is even more acute.[231] He may have to show that no undue influence was exerted.[232]

3.4.6 There are two exceptions to the rule requiring full disclosure.[233] The first is where a broker sells to a customer off his own book. Provided he does not charge commission, disclosure of the fact that he is acting as principal is "sufficiently full and accurate"[234] and he will not have to reveal details of the price at which he bought or the turn which he makes. This does not derogate from his duty to act honestly and faithfully towards his customer and not to conceal material facts in order to obtain an advantage for himself.[235] However, it is not sufficient to state in small type which might easily escape the attention of the customer "Where no commission is charged this contract is issued by us as principals, and not as brokers or agents", or when dealing with inexperienced customers, to use the words "sold to" in place of "bought for".[236]

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[230] *Gibson* v. *Jeyes* (1801) 6 Ves. 266, 278; *Savery* v. *King* (1856) 5 H.L.C. 627, 655. See also Finn, *Fiduciary Obligations* (1977), paras. 439-440, and the cases cited therein.

[231] *Brown* v. *I.R.C.* [1965] A.C. 244, 262.

[232] For example *Savery* v. *King* (1856) 5 H.L. 627, 655; *Wright* v. *Carter* [1903] 1 Ch. 27; *Allison* v. *Clayhills* (1907) 97 L.T. 709, 711-12; *Demerara Bauxite Co. Ltd.* v. *Hubbard*, above; *Moody* v. *Cox and Hatt* [1917] 2 Ch 71; *Ex p. Lacey* (1802) 6 Ves. Jun. 625. See further Sheridan, *Fraud in Equity* (1957), at 90-93.

[233] In addition to the situation where a lesser level of disclosure suffices as a matter of custom, as to which see Section 3.2, above.

[234] *Trustee of Ellis and Co. (bankrupts)* v. *Watsham* (1923) 155 L.T. Jo. 363. See also *Chesterfield & Boythorpe Colliery Company* v. *Black* (1878) 37 L.T. 740.

[235] *Chesterfield & Boythorpe Colliery Company* v. *Black* (1878) 37 L.T. 740; *Regier* v. *Campbell-Stuart* [1939] Ch.766, 768-9.

[236] *Re Wreford, Deceased* (1897) 13 T.L.R. 153; *Re Arthur Wheeler & Co.* (1933) 102 L.J. Ch. 341.

3.4.7 The second exception is where, in accordance with the usual practice of the business in which he is operating, an agent receives remuneration from a third party in the form of a commission or discount.[237] Provided that the principal is aware that the agent will be remunerated in this way,[238] does not make further enquiry,[239] and is not misled by the agent as to amount,[240] the agent does not have to disclose the amount of or basis on which the commission is paid. The agent's right to retain a usual allowance may be ousted by the terms of his contract with his principal.[241]

3.4.8 Two elements of this require further consideration. The first is what constitutes "usual practice". It has been described variously as "well-established",[242] "well-known",[243] "recognised by everybody connected with the business",[244] "generally known and acquiesced in",[245] "the ordinary understanding of persons who entered into such business",[246] and "the usual or normal commission in that line of insurance".[247] The test seems similar to that of uniformity, notoriety and certainty by which purported trade customs are assessed.[248] The type of transaction and the means, for example, commission or discount, and quantity of remuneration must all accord with usual practice. Regulatory rules will be influential in determining usual practice.

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[237] *Great Western Insurance Co.* v. *Cunliffe* (1874) L.R. 9 Ch. App. 525; *Baring* v. *Stanton* (1876) 3 Ch. 502; *Lord Norreys* v. *Hodgson* (1897) 13 T.L.R. 421; *Workman* v. *London & Lancashire Fire Insurance Co.* (1903) 19 T.L.R. 360, 362; *N. V. Rotterdamse Assurantiekas* v. *Golding Stewart Wrightson Ltd. & Others*, 13 January 1989, (Lloyd. L.J. and Sir Roger Ormrod).

[238] See n. 229, above and *Hippisley* v. *Knee Brothers* [1905] 1 K.B. 1, 6; *Copp* v. *Lynch and the Law Life Assurance Company* (1882) 26 S.J. 348.

[239] *Great Western Insurance Company* v. *Cunliffe*, above, 539-540; *Baring* v. *Stanton*, above, 505, 507.

[240] *E. Green and Son (Limited)* v. *G. Tughan and Co.* (1913) 30 T.L.R. 64,65.

[241] *Hippisley* v. *Knee Brothers*, above.

[242] *Great Western Insurance Company* v. *Cunliffe*, above, 537.

[243] *E. Green and Son (Limited)* v. *G. Tughan and Co.* (1913) 30 T.L.R. 64, 65.

[244] *Great Western Insurance Company* v. *Cunliffe*, above.

[245] *Baring* v. *Stanton*, above, 506.

[246] *Lord Norreys* v. *Hodgson*, above at 422.

[247] *N. V. Rotterdamse Assurantiekas* v. *Golding Stewart Wrightson Ltd. & Others*, above. For an example of a practice which is not usual see *The Liquidators of the Imperial Mercantile Credit Association* v. *Coleman and Knight* (1873) L.R. 6 H.L. 189, 202.

3.4.9 The second is the requirement of knowledge of the practice on the part of the principal. This may be actual or implied.[249] Knowledge will be inferred more readily where the agent is operating in his usual line of business, such as where he is an insurance broker, than where he is, for example, a solicitor arranging insurance for a customer.[250] Another relevant factor is whether the principal has made any other arrangements for the remuneration of the agent in respect of the transaction in question.[251]

3.4.10 There has been no judicial consideration of whether another element must be present, that the practice be reasonable, as it must if it is to constitute a binding custom.[252] The rationale for permitting a reduced level of disclosure is that the principal is aware of the practice, if not the amount of remuneration. The question of reasonableness is thus of concern only in relation to amount. The courts may have taken the view that the requirement of normality provides sufficient protection against excess charges. We consider it unlikely that they would sanction payment of an unreasonable sum which was unknown to the customer, even if it was paid in accordance with a usual practice.

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[248] See paras. 3.2.2-3.2.6, above.

[249] *Great Western Insurance Company* v. *Cunliffe*, above; *Lord Norreys* v. *Hodgson*, above; *E. Green and Son (Limited)* v. *G. Tughan and Co.*, above; *Hippisley* v. *Knee Brothers* [1905] 1 K.B. 1, 7.

[250] *Workman* v. *London and Lancashire Fire Insurance Co.*, above, 362; *Copp* v. *Lynch and The Law Life Assurance Co.* (1882) 26 S.J. 348. See also *Baring* v. *Stanton*, above; *Brown* v. *I.R.C.* [1965] A.C. 244.

[251] *Great Western Insurance Company* v. *Cunliffe*, above; *Baring* v. *Stanton*, above; *Stubbs* v. *Slater*, above.

[252] See para. 3.2.13, above.

3.4.11 The disclosure obligation extends to all material information which the fiduciary acquires after the commencement of the relationship, no matter "how or under what circumstances [it] was gained".[253] It may also comprehend information obtained in a different capacity prior to the commencement of the relationship.[254] There is Commonwealth authority that there is no obligation to disclose facts of which the fiduciary is unaware "notwithstanding that prudent enquiry would reveal their existence", provided that the fiduciary has not deliberately refrained from acquiring them.[255]

Timing of Disclosure

3.4.12 Disclosure may be made at any time between the creation of the fiduciary relationship and the act or omission which would otherwise constitute a breach of duty, or it may be made after the breach of duty has occurred,[256] for example on a contract note.[257] Where disclosure is made after the breach it cannot serve to prevent a cause of action accruing to a beneficiary who does not choose to consent. If the risk of liability is to be avoided should the customer decline to consent, it is essential, in the absence of an effective trade custom validating the relevant practice,[258] to make sufficient disclosure prior to the breach of duty. In certain circumstances it will be impossible or impracticable to do this.

3.4.13 For example, in relation to dealing on its own account the firm is unlikely to know in advance whether it has acted as principal and disclosure can only be made on the contract note. In practice, dual-capacity is often disclosed twice, firstly on the customer agreement by a statement that the broker/dealer may act as principal or agent, and secondly by a precise disclosure of capacity on the contract note. Where this double disclosure is made it would seem harsh to hold the broker/dealer liable for acting as principal, particularly if it was impossible for it to make the requisite disclosure in advance. However, if the disclosure in the customer agreement is inadequate in terms of consent,[259] in the absence of an effective custom to the contrary[260] or the clause being held to define the parties' respective rights and duties *ab initio*,[261] it is difficult to see on what basis a customer who refused to accept the disclosure on the contract note could be bound by it. A firm whose customer agreement states that it may sometimes act as principal and sometimes as agent, that it is impossible or impracticable for it to disclose in advance in which capacity it is acting and that disclosure of its status in relation to any particular transaction will only be made on the contract note, may be in a stronger position. If the customer accepts such an agreement it will be difficult for him to show that he did not consent to late disclosure. Then, provided that the firm did not take advantage of the customer and the transaction was fair,[262] it should be protected.

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[253] *Dougan* v. *MacPherson* [1902] A.C. 197, 204-5.

[254] *Moody* v. *Cox and Hatt* [1917] 2 Ch. 71.

[255] *B.L.B. Corporation of Australia Establishment* v. *Jacobsen* (1974) 48 A.L.J.R. 372, 378. See also *Mouat* v. *Clark Boyce* (1991) 1 N.Z. Conv. C. 190, 917 at 190,939.

[256] *De Bussche* v. *Alt* [1878] 8 Ch. 286, 312-3; *Harrods Ltd.* v. *Lemon* [1931] 2 KB 157; *Thornton Hall and Partners* v. *Wembley Electrical Appliances Ltd.* [1947] 2 All E.R. 630.

[257] *Trustees of Ellis and Co.* v. *Watsham* (1923) 155 L.T. Jo. 363; *Re Wreford, Deceased* (1897) 13 TLR 153; *Re Arthur Wheeler & Co.* (1933) 102 L.J. Ch. 341.

[258] See Section 3.2, above.

3.4.14 Even if advance disclosure, for example, that the firm might match the transaction undertaken on behalf of the customer with that undertaken for another, is made, further disclosure may be necessary if an actual conflict arises between the duties owed to each customer. A customer's consent to his agent acting for another party, which will allow the agent to occupy a position where there is or may be a conflict between his interest and duty or between the duties owed to the customer and the other party, does not without more amount to consent to a reduction in the duties owed to him.[263] The fact that complying with the full range of duties would mean breaching those owed to another customer is not a defence.[264] Thus, if an actual conflict does arise, for example, if the agent receives confidential information from one customer which is pertinent to the other, the fact that he had obtained the consent of the second customer to his acting for both would not, in the absence of an appropriately worded contractual provision,[265] constitute a defence to an allegation that he had failed to disclose the information. At this stage, if he is to be protected from liability, he must disclose to the second customer all material facts bearing on the conflict and obtain his consent (which he would be free to withhold) to non-disclosure. In many cases it will be impossible to make sufficient disclosure at the commencement of the relationship as material information which has to be disclosed will not be known and cannot be predicted until a particular conflict arises. Additional disclosure may also be necessary if the relationship between agent and customer evolves over time, imparting higher levels of fiduciary duty.[266] There is thus considerable doubt whether the advance disclosures made in customer agreements are effective in any but the simplest cases to deal with conflicts of interest at common law and in equity.

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[259] As to which, see para. 3.4.33, below.

[260] See Section 3.2, above.

[261] See paras. 3.3.10-3.3.12, above.

[262] Where the customer is a private customer, or where the firm fulfils an order from a non-private customer, (for definitions see SIB, The Financial Services Glossary 1991, Appendix 3 below), the firm must provide best execution, SIB Core Rule 22, SFA Rule 5-39.

[263] *B.L.B. Corporation of Australia Establishment* v. *Jacobsen* [1974] 48 A.L.J.R. 372, 377.

Form of Disclosure

3.4.15 Disclosure may be oral or in writing. As the onus of proving that adequate disclosure was made rests on the fiduciary[267] it is advisable for him to confirm oral disclosure in writing. The responses to the Issues Questionnaire revealed that in the financial services industry it is most commonly made in writing, for example, in customer agreements, on contract notes, and on research publications. We shall therefore consider whether it is sufficient to give the customer written terms and conditions setting out details of the matter to be disclosed without further explanation, or whether more is required.

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[264] *Goody* v. *Baring* [1956] 1 W.L.R. 448, 450; *Moody* v. *Cox and Hatt*, [1917] 2 Ch. 71, 84-5. (In this case the plaintiff did not specifically consent to the agent acting for other party, but knew that the agent was so acting when he employed him.)

[265] See paras. 3.3.20 and 3.4.3, above.

[266] See para. 3.3.22, above.

[267] See para. 3.4.4, above.

3.4.16 If sufficiently informed consent is to be obtained, the customer must "fully understand not only what he is doing but also his legal rights and that he is in part surrendering them."[268] The function of disclosure is to enable the fiduciary to obtain such consent, and what is required will depend on the level of expertise and understanding of the individual customer. The more unusual the clause or the less experienced the customer, the higher the degree of notice required to bring it to his attention.[269] Where the customer is inexperienced this may require more than the mere provision of formal disclosure in documentary form. It may necessitate drawing his attention to the disclosure clause and explaining in non-technical language the pertinent points and the effect that consent will have on his rights. Where the fiduciary is an adviser, for example a solicitor, it may be desirable to refer the customer to an independent adviser for advice on whether to consent.[270]

Circumstances In Which Consent Cannot Constitute A Defence

3.4.17 The customer's consent can never constitute a defence to breach of fiduciary duty where, no matter how thorough the disclosure, it is impossible to obtain sufficiently informed consent. The matter in question may be so complex and technical, the conflict so acute[271] and the customer's understanding and experience so limited that, however full any disclosure made to him, it is impossible to place him in a position where he has sufficient comprehension of the issues and consequences of consenting to give binding consent.[272] Beyond this we consider that no matter how severe a conflict may be, if a customer fully understands the consequences of the fiduciary acting in the conflict situation and gives consent, there can be no objections to the fiduciary acting. In practice, if a conflict is very acute, there will always be a strong probability that the customer will not be treated as having consented. SIB Principle 6 recognises that there may be circumstances in which it is appropriate to decline to act in a situation of conflict.[273]

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[268] *Boulting* v. *Association of Cinematograph, Television and Allied Technicians*, above, at 636.

[269] See, for example, *Re Wreford, Deceased*, above; *Interfoto Picture Library Ltd.* v. *Stiletto Visual Programmes Ltd.* [1989] Q.B. 433, 440-5, and the cases cited therein.

[270] See, for example, *Pisani* v. *The Attorney General for Gibraltar* (1873-4) L.R. 5 P.C. 516; *Goody* v. *Baring* [1956] 1 W.L.R. 448. See further *Cordery*, at 11.

[271] *Farrington* v. *Rowe McBride & Partners* [1985] 1 N.Z.L.R. 83, 90.

[272] See also Finn "Conflicts of Interest and Professionals", in *Professional Responsibility* (Legal Research Foundation, Auckland 1987), 9, at 28-9.

3.4.18 We will now illustrate these propositions concerning the content, timing and form of disclosure by way of particular examples.[274]

Disclosure of Commission

3.4.19 In order for an agent to take a commission, full disclosure must be made to his customer.[275] This extends to disclosure of the amount of commission and the method and timing of payment. In relation to private customers, Core Rule 18(2) permits disclosure of only the "basis" of commission.[276] Unless validated by custom,[277] or within the "usual practice exception",[278] disclosure of only the basis of commission is unlikely to satisfy common law and equitable requirements.[279]

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[273] See further Section 4.3, below.

[274] We will not consider collective investment schemes in this context as we believe that public law provides a solution to any problems which would otherwise be encountered in relation to them, see further para. 5.3.4, below.

[275] See para. 3.4.4, above.

[276] See further, paras. 5.3.13-5.3.15, below. The rule is set out in Appendix 3.

[277] See Section 3.2, above.

[278] See para. 3.4.7-3.4.10, above.

[279] Unless Core Rule 18 is accorded some special status, as to which see Part V, below.

3.4.20 In relation to packaged products,[280] commission is usually paid by the product provider rather than the customer. Independent intermediaries[281] authorised by FIMBRA who are remunerated in this way are required to disclose to the customer before recommending a transaction the fact that the product provider will in due course give him information about that commission.[282] Provided that the amount of commission is normal, the payment of commission by the product provider will fall within the "usual practice" exception.[283] It is therefore unnecessary to disclose the amount or basis of commission, and disclosure in accordance with the regulatory rules is sufficient.

Double Agency : Acting for Both Parties

3.4.21 As a general rule "fully informed consent apart, an agent cannot lawfully place himself in a position in which he owes a duty to another which is inconsistent with his duty to his principal."[284] In order to obtain such consent and enable an agent to act for both parties to a transaction disclosure must be made to each principal of the fact that the agent will be acting for the other, the full implications of this,[285] for example, that the agent will not be able to perform his full duties of disclosure[286] if he obtains relevant information in confidence from the other,[287] and "the exact nature of [the agent's] interest" including, where appropriate, the fact that he will obtain commission from each.[288] There may be an exception to the requirement for disclosure of double commission if it is shown that it is usual practice to act as dual agent and take commission from both parties, and that the customer is aware of that practice.[289] In the case of a private customer it could be hard to prove knowledge of the practice unless it was specifically disclosed to him, since, having made arrangements to pay the agent, the customer will not expect the agent to receive additional remuneration from a third party.

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[280] I.e. life policies and units in regulated collective investment schemes or investment trust savings schemes.

[281] The timing and content of commission disclosure by independent intermediaries is being reviewed by the SIB; SIB, Retail Regulation Review, Discussion Paper 3, *Disclosure* (October 1991), and SIB, Retail Regulation Review, Consultative Paper 60, *Disclosure, Polarisation, and Standards of Advice* (March 1992). See para. 5.3.13, below, for the rules on disclosure in relation to tied agents.

[282] FIMBRA Conduct of Business Rules, Rule 4.6.3(2). See also Rule 4.6.4 where the product provider is not an authorised person.

[283] See paras. 3.4.7-3.4.10, above.

[284] *North and South Trust Co.* v. *Berkeley* [1971] 1 W.L.R. 470, 484-485. See also *M'Devitt* v. *Connolly* (1885) 15 L.R. Ir. 500, 501, 502; *Imeson* v. *Lister* (1920) 149 L.T.Jo. 446; *Eagle Star Insurance Co. Ltd.* v. *Spratt* [1971] 2 Lloyd's Rep. 116, 133.

[285] *Anglo-African Merchants Ltd.* v. *Bayley* [1970] 1 Q.B. 311, 323.

[286] If these have been effectively modified by contract (see paras. 3.3.20, 3.4.3 and 3.4.13, above) this may not be a problem.

3.4.22 There is some authority that it is sufficient merely to disclose that the agent is acting for both customers.[290] However, as we have already seen,[291] this will only provide protection so long as no actual conflict arises between the duties owed to each.

3.4.23 A common example[292] of dual agency is that of a stock broker carrying out an agency cross, simultaneously matching the transactions undertaken by two customers and taking commission from each. Rule 5-33(3) of the SFA Conduct of Business Rules provides that where a broker carries out an agency cross it is not necessary for him to disclose either the nature or amount of commission received from one customer to the other. However, where the firm is required to send a contract note to the customer it must state on the note "the amount or basis of any remuneration which the firm has received or will receive from another person in connection with the transaction, or the fact that this will be made available on request."[293] Non-disclosure of commission as permitted by Rule 5-33(3) or disclosure of only the basis of commission on the contract note in accordance with Rule 5-34, will only suffice to avoid breach of fiduciary duty at common law and in equity if the practice of taking double commission is upheld as usual. This necessitates showing, firstly, that the practice is usual and, secondly, that the customer was aware of it.[294]

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[287] *Moody* v. *Cox and Hatt*, above, 81. Where commission is taken from the other customer, this does not extend to informing the first that the firm would be liable to him if it had not disclosed the commission to him: *Re Haslam & Hier-Evans* [1902] 1 Ch. 765, 772.

[288] *Fullwood* v. *Hurley* [1928] 1 K.B. 498.

[289] On the grounds set out in paragraphs 3.4.7-3.4.10, above. This would only provide protection in respect of an allegation that the agent had taken a 'secret profit', and not in respect of an allegation of breach of the obligation of undivided loyalty should an actual conflict arise. See para. 3.4.14, above.

[290] *Thornton Hall and Partners* v. *Wembley Electrical Appliances Ltd.* [1947] 2 All E.R. 630; *M'Devitt* v. *Connolly*, above.

[291] See para. 3.4.14, above.

[292] Another example is that of a broker fund adviser acting as "adviser" to a customer when recommending an investment in a broker fund of which he is "manager". See further SFA Rule 5-22(10),(11), 5-35(10), 9-1; SIB, *Broker Funds and Broker Unit Trusts: A Policy Statement* (February 1990); SIB, Consultative Paper 46, *Broker Funds: Future Regulation* (November 1990); SIB, *Regulation of Broker Funds: Policy Statement* (May 1991).

3.4.24 Most customer agreements disclose the fact that the broker might match the customer's transactions with those of another customer. Where a customer has contracted on such terms the second criterion is easily fulfilled. However, it may be harder to show that transactions are "usually" matched. The cases in which commissions have been upheld as paid in accordance with usual practice have all related to the payment of commission by the product provider to insurance brokers in circumstances where commission was invariably deducted from premium. Brokers do not carry out agency crosses with the same degree of regularity so it is open to question whether it is usual practice for them to do so. The answer may depend on whether "usual practice" refers to the totality of transactions or those in which it is open to a broker to match.

3.4.25 Even if the payment of dual commission is upheld as usual, or the amount of the commission is disclosed on the contract note, the firm will only be protected against allegations that it has taken a secret profit. It would still be vulnerable if an actual conflict arose, for example, if one customer disclosed to it that it was seeking to build up a large stake in the relevant stock which would push the price of that stock up. Then, unless it had disclosed to the second customer that it might acquire information from the first which would be relevant to the transaction being undertaken on his behalf which it would not be free to communicate to him and the possible consequences of this for him, it would risk liability for breach of its duty of undivided loyalty to the latter.[295] If the necessity for further disclosure at the time of the transaction is to be avoided it is thus necessary to predict and disclose in the customer agreement all the conflicts which might arise in the course of acting as a dual agent and their consequences for the customer. In practice, this is unlikely to be feasible.

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[293] Table 5-34(2), para. 8.

[294] See paras. 3.4.7-3.4.10, above.

Soft Commission Arrangements[296]

3.4.26 A few consultees highlighted the problems caused by soft commission arrangements whereby a broker/dealer provides goods or services to a fund manager in return for a guarantee that the manager will provide it with a specified minimum amount of business.[297] Such arrangements give rise to conflicts between the manager's duty and interest and breach the prohibition on secret profits. Core Rule 3[298] provides that soft commission arrangements may only be utilised where "adequate prior and periodic disclosure is made." IMRO Rules provide that before a firm enters into a customer agreement authorising the effecting of transactions with or through the agency of a person with whom the firm has a soft commission agreement, the firm must inform the customer in writing of the existence of the agreement and of the firm's policy relating to soft commission agreements.[299] In addition, the firm must submit an annual report to the customer giving details of, amongst other matters, the percentage of total commission paid by the firm under soft commission agreements, the value of goods or services received by the firm under soft commission agreements as a percentage of total commissions paid by the firm, a summary of goods or services received under soft commission agreements, and the total commission paid from the portfolio of the customer.[300] We will now assess whether this level of disclosure will constitute a defence to an allegation of breach of fiduciary duty.

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[295] See para. 3.4.14, above.

[296] See generally, SIB, Consultative Paper 46, *Soft Commission Arrangements in The Securities Markets: 'Soft for Net'* (November 1990); SIB, *Soft Commission Arrangements in the Securities Markets A Policy Statement* (July 1990); SIB, *Soft Commission Arrangements in the Securities Markets Second Policy Statement* (February 1991); SIB, Consultative Paper 56, *Soft Commission - Recent Developments* (December 1991).

[297] "Soft for net" arrangements with market-makers remunerated by spread alone are prohibited by Rule 3d of the SIB's Core Rules for the Conduct of Investment Business. See further Blair, *Financial Services - The New Core Rules*, 1991, at 56-7.

[298] Set out in Appendix 3.

[299] Rule 1.7(3). See also SFA Rule 5-8(3).

3.4.27 Where the soft commission arrangements are entered into after the commencement of the relationship with the customer, even if provision of the policy statement constitutes adequate disclosure, the customer will be free to withhold his consent, in which event the firm will be in breach of duty if it carries out transactions for him pursuant to the arrangements. Where the policy statement is given to the customer before the commencement of the relationship or he accepts it, much will depend on the contents of the statement and the customer's experience. In relation to the conflict of duty and interest, a combination of the disclosure of the arrangements in the written statement, which will protect the manager from liability for placing himself in a position of potential breach of duty, and the requirements for best execution and no price disadvantage to the customer in Core Rule 3, which should prevent an actual breach occurring, should be sufficient. With regard to the secret profit element, further disclosure may be necessary.

3.4.28 It is unlikely that soft commission arrangements are sufficiently universal to come within the "usual practice" exception outlined above. In order to retain the goods or services the firm will therefore have to disclose the precise proportion attributable to the customer's transactions and obtain his consent to its retention. This is impracticable and where the customer is experienced, comprehends the annual information and understands how the arrangements work and that he will not be provided with details of the benefit referable to his business, a court might hold that disclosure in accordance with the IMRO Rules satisfies common law and equitable requirements.[301] Where the customer is less knowledgeable, at a minimum we consider that it is necessary to explain exactly how the arrangement works, its implications for him and the fact that the firm will neither account for nor disclose to him the amount of goods/services attributable to his business.[302] The disclosure contemplated by the IMRO Rules is, therefore, unlikely to satisfy common law and equitable requirements in relation to an inexperienced customer.[303] This is particularly so in the case of a private customer where the regulatory rules may not require disclosure of any details of the goods or services received by the firm unless they are specifically requested.[304]

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[300] Rule 1.7(4). See also SFA Rule 5-8(4).

Limitation or Abrogation of Duty of Undivided Loyalty : Conflicting Duties of Confidence and Disclosure

3.4.29 We will now consider the example of a firm, the corporate finance department of which acquires information from a customer which has a bearing on the market price of that customer's securities. Its broker/dealer department is advising other customers in that security. Because of the rules on attribution,[305] there will inevitably be a breach of duty to one or other of the customers; if the broker/dealer department does not advise its customer on the basis of the information there will be a breach of duty to that customer, if it does so advise there will be a breach of duty to the corporate finance department's customer. Unless Chinese walls and independence policies are effective as a means of resolving conflicts either in themselves[306] or as a matter of public law,[307] there will thus be problems where the broker does not possess the information because it is on the other side of a Chinese wall, or where he is bound by a policy of independence to disregard it.[308] We will now examine what the firm must divulge to the broker/dealer department's customer in order to limit or abrogate the duty of undivided loyalty to the extent necessary to permit it to withhold the information.

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[301] See *Boulting* v. *Association of Cinematograph, Television and Allied Technicians* [1963] 2 Q.B. 606, 638: the conflict rule "must be applied realistically to a state of affairs which discloses a real conflict of duty and interest and not to some theoretical or rhetorical conflict."

[302] The fact that Core Rule 3a. provides that the goods/services must be used for the benefit of all customers will not be a defence to breach of fiduciary duty. If the manager is to comply with his duty, in the absence of the customer's informed consent it will have to give or to utilise exclusively for the customer that part of the goods which is referrable to his transactions.

[303] Unless some special status is accorded to the rules of SROs, as to which see Part V, below.

[304] SFA Rule 5-8(4)(c)(ii)(bb).

[305] See Section 2.3, above.

[306] See Section 4.5, below.

3.4.30 While the firm would not be compelled to disclose or utilise the information when advising the broker/dealer department's customer,[309] as we have already seen, the fact that it owes a duty of confidentiality to the corporate finance department's customer will not constitute a defence to a breach of duty to the broker/dealer department's customer.[310] If the firm is to be protected, it must obtain the broker/dealer's customer's consent to its acting after informing him of its conflicting duties and the fact that it cannot perform its full duties of disclosure,[311] or refuse to accept his business.[312] If an advance disclosure is to suffice it will probably[313] be necessary for it to explain the circumstances in which the firm might receive and withhold information, the fact that the information will be price-sensitive and the consequences of non-disclosure for the customer. It would be difficult to draft a general clause predicting in advance all the possible eventualities, and it is likely that whatever type of clause is used, further disclosure would be necessary as particular conflicts come to light.

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307. See Part V, below.

[308] SFA Rules 5-29; see further Section 4.4, below.

[309] *North and South Trust Co.* v. *Berkeley* [1971] 1 WLR 470, 486.

[310] *Moody* v. *Cox and Hatt* [1917] 2 Ch. 71, 81; *Goody* v. *Baring* [1956] 1 W.L.R. 448, 450. See para. 3.4.14, above.

[311] On contractual exclusion of a duty to disclose information acquired in confidence from a third party, see paras. 3.3.20 and 3.4.3, above.

[312] *Moody* v. *Cox and Hatt*, above. If the firm is already acting for the customer it is possible that declining to act could in itself constitute breach of fiduciary duty, as to which see para. 4.3.5(ii), below.

[313] Particularly in the case of an inexperienced customer who might be ignorant of the operations of a financial conglomerate and the existence of independence policies and Chinese walls.

3.4.31 Most consultees indicated that their customer agreements do not reveal that they might be utilising Chinese walls. However, a number said that their agreements provide that the firm is not obliged to disclose to the customer, or take into account when acting for him, any information known to any person(s) within the firm if it has not come to the notice of the individual with whom he is dealing. These clauses are very broad and do not set out the types of information which may be withheld, the circumstances in which relevant information might come into the firm's possession, or the possible consequences of non-disclosure for the customer. It is very doubtful whether this level of disclosure would protect the firm against allegations of non-disclosure of material information, particularly where the customer is inexperienced.

3.4.32 SFA rule 5-29(3) provides, in respect of private customers, that where a firm relies on a policy of independence it must disclose that it may give investment advice where it has a relationship which may give rise to a conflict of interest in relation to that transaction and that the individual with whom the customer is dealing is required to comply with the policy and disregard the conflict of interest when making recommendations or arranging transactions. It is not required to set out the circumstances in which it might have such a relationship or the possible implications of non-disclosure for the customer. The guidance to SFA Rule 5-29 assumes that further specific disclosure may have to be made. This will probably be necessary if common law and equitable disclosure requirements are to be satisfied as it is very uncertain whether disclosure in accordance with the Rule would, on its own, provide a safe harbour.

Disclosure of Self Dealing

3.4.33 Here we consider what must be disclosed in order to overcome the prohibition on a broker/dealer acting as principal and selling or buying stock to or from a customer off or for its own book in the course of a fiduciary relationship.[314] "Full and accurate disclosure" of the broker's self-dealing is required and his customer must consent with "full knowledge" of the facts.[315] As we have already seen, where no commission is charged and the broker is acting honestly, clear disclosure of the fact that he is acting as principal is sufficiently full and accurate.[316] However, in the case of an inexperienced customer it is insufficient merely to substitute "sold to" for "bought for" on the contract note. It is necessary to make it "perfectly plain" to him that the broker is acting as principal rather than agent in the transaction.[317] An indication on the contract note that a broker was acting as principal may be rebutted by other evidence as to the capacity of the broker, for example representations made on circulars issued by him.[318]

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[314] For example, *Gillett* v. *Peppercorne* (1874) 3 Beav. 78, 83; *King Viall and Benson* v. *Howell* (1910) 27 T.L.R. 114; *Aston* v. *Kelsey* [1913] 3 K.B. 314, 321; *Oelkers* v. *Ellis* [1914] 2 K.B. 139, 146-7.

3.4.34 In an ordinary broking transaction,[319] where there has been no dishonesty on the part of the broker and there are no other indications as to his capacity, disclosure on the contract note in accordance with SFA Table 5-34(2), paragraph 11 will be sufficient.[320] It is not clear whether the court would adopt the same approach in relation to an advance disclosure of the fact that the firm might sometimes act as principal, of the type commonly inserted in discretionary management customer agreements. The relevant cases all concerned disclosure on contract notes. Advance disclosure may be distinguished from that on the contract note as in respect of any particular transaction it does not enable the principal to know in which capacity his agent is acting. Unless advance disclosure clauses are regarded as circumscribing the respective rights and duties of the parties,[321] or self-dealing is permitted without disclosure,[322] they are likely to be ineffective as a means of avoiding liability for breach of duty.

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[315] *Armstrong* v. *Jackson* [1917] 2 K.B. 822, 824. See also *Aston* v. *Kelsey*, above, 321-2; *Dunne* v. *English*, above; *Estate Realties Ltd.* v. *Wignall* [1991] 3 N.Z.L.R. 482, 492.

[316] See para. 3.4.6, above.

[317] *Re Wreford, Deceased* (1897) 13 T.L.R. 153.

[318] *Re Arthur Wheeler & Co.* (1933) 102 L.J. Ch. 341, 344.

[319] I.e. a transaction which falls within SFA Rule 5-34(1).

[320] Provided that the customer does not refuse to accept this late disclosure: see paras. 3.4.12-13, above.

[321] See paras. 3.3.10-3.3.12, above.

3.4.35 Disclosure of the fact that the broker is acting as principal with respect to the transaction is unlikely, on its own, to suffice if there exist any other material matters which could affect the customer's decision to proceed with the transaction.[323] For example, if the broker acquired the stock with a view to selling it on to the customer at a profit it would have to disclose this fact, the historic price of the stock, the current market price of the stock, and the profit made on the sale.[324] Any other relevant matters would also have to be disclosed, for example that the stock was the "rump" of a rights issue placed by the firm.[325] If the special circumstances of the relationship between broker and customer could give rise to undue influence the disclosure obligation will be even more onerous.[326]

3.4.36 Finally, it should be noted that where a fiduciary buys from or sells to a beneficiary it must show that the transaction was fair both as to price and otherwise.[327]

Provisional Conclusion

3.4.37 As a general rule, fiduciary duties may be modified or displaced if the beneficiary's consent is obtained after making full disclosure of all material facts. However, it is impossible to set out a precise formula for ascertaining what must be disclosed in any particular circumstances. In some situations it will be impossible to obtain sufficiently informed consent, no matter how full the disclosure.

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[322] See paras. 3.2.17 - 3.2.25, above.

[323] See para. 3.4.14, above.

[324] *Regier* v. *Campbell Stuart*, above.

[325] There may be other problems associated with this practice, but these are of no concern to us here.

[326] See para. 3.4.5, above.

[327] See, for example, *Allison* v. *Clayhills*, above; *Gibson* v. *Jeyes*, above; *Pisani* v. *Attorney General for Gibraltar*, above; *Demerara Bauxite* v. *Hubbard*, above; *Re Haslam and Hier Evans*, above. If full value is not given the transaction may be upheld as a gift made of the customer's own free will and with full understanding: see further Finn, *Fiduciary Obligations* (1977), chap. 16 and para 434.

3.4.38 Where it is possible to assess what must be disclosed, it will often be impossible or impractical to divulge the requisite information in advance of the breach of duty, or at all. For example, a broker/dealer may not know at the time of a particular transaction whether it is executed off its own book. Where soft commission is taken it may be impossible to assess what part of the benefit received by the broker/dealer is attributable to transactions carried out on behalf of the customer. If advance disclosure cannot be made the firm must bear the risk that the customer may choose not to consent. Where disclosure is made, a conflict which was not predicted may subsequently arise leaving the firm open to liability. It is unlikely that the disclosure clauses in customer agreements can cover all eventualities in sufficient detail. There is also considerable doubt as to whether compliance with the disclosure requirements of the regulatory rules will satisfy general law requirements,[328] for example, where a broker takes soft commission.

3.4.39 The uncertainty surrounding what must be disclosed in order to obtain sufficiently informed consent, and the practical problems encountered in making adequate disclosure mean that disclosure and consent cannot be depended on as a method of displacing or modifying fiduciary duties save in the exceptional circumstances where full disclosure is not required[329] or a lesser form of disclosure is validated as a binding custom.[330] Thus, disclosure and consent are not a reliable means of avoiding conflicts between fiduciary law and what is required or permitted by the regulatory rules.

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[328] Unless public law affords special status to the regulatory rules, as to which see Part V, below.

[329] See paras. 3.4.6 - 3.4.10, above.

[330] See paras. 3.2.2 - 3.2.7, above.

PART IV

STRUCTURAL TECHNIQUES FOR MANAGING CONFLICTS

4.1 In this section it is proposed to deal with structural solutions to the problem of conflict, that is organisational arrangements put into place by the firm either on its own initiative or because they are required or facilitated by regulatory rules. We will consider the effectiveness in both legal and practical terms of policies of enforced separation, the placing of specific prohibitions on particular types of acute conflict, independence policies and Chinese walls.

4.2 Elimination of Conflicts

4.2.1 One way of dealing with conflicts is a policy of enforced separation which would oblige firms to carry on within a separate legal entity only those activities that do not result in conflict. This would avoid the problems which arise as a result of attribution of knowledge.[1] There appears to be general agreement among the respondents to the Issues Questionnaire that this enforced separation of functions is not feasible and in many respects is not desirable.[2] A number of points were made as to why enforced segregation into separate legal entities was not a feasible or satisfactory answer to the problems of conflict. The separate entities would often not be economically viable (this would be the case with the smaller firms); certain economies of scale would be lost (for example, a research department can service a number of departments within a firm); enforced separation could give rise to regulatory difficulties where, for example, it resulted in the diversified entity not having a sufficient capital base to comply with any prescribed capital adequacy rules;[3] if the firm's profit centre is a wholly owned subsidiary of a parent owing fiduciary duties to its customers, compulsory segregation will not solve the problem of conflict; customers of a financial conglomerate often benefit from the fact that it carries on a range of activities.[4] It would also appear that international trends indicate the formation of all purpose banking and financial services groups and any policy of enforced segregation could impair the international competitiveness of United Kingdom financial conglomerates. A number of the respondents to the Issues Questionnaire do conduct certain aspects of their business in different companies. This was for a combination of reasons, one of which was the desire to avoid conflict, but regulatory, commercial and tax reasons also played a role.

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[1] See Section 2.3, above.

[2] See Appendix 1, Q. 7.3. See also "The Use of Confidential Price-Sensitive Information", The Panel on Take-overs and Mergers, Report for the Year ended 31st March 1970, Appendix I at 10. For the American position, which would also be relevant to the United Kingdom, see Lipton and Mazur, "The Chinese Wall Solution To The Conflict Problems of Securities Firms", (1975) 50 N.Y.U.L.R. 459, at 494-496 (detailing the shortcomings of a policy of compulsory separation of functions).

4.2.2 The point was also made by a number of respondents that, were separate legal entities to be required, it would still be necessary to ensure that information was not improperly leaked from one legal entity within a group to another entity within the same group. For example, a director who was a member of a number of boards of directors of companies within the group, or a director of a subsidiary who served on the board of the parent company, would have to be constrained from divulging confidential information obtained in one capacity with respect to functions carried out in another capacity.[5] Even outside these situations of shared personnel, some respondents made the point that separate corporate structures would create a formal separation but would not necessarily curb the flow of information between the separate entities within a group of companies.[6] In addition, separate legal entities would not resolve the conflicts which occur within a single company. For example, if the broking function was segregated conflicts would still arise where the broker received information from one customer which could affect the decision of another customer whether or not to proceed with a transaction. An example of this is where a broker receives instructions from one customer to sell a large shareholding in a particular company while advising another customer whether or not to purchase shares in that company. Thus while conflicts arising in a world of segregation might be reduced they would not be eliminated: segregation is not a completely sufficient answer to all problems.

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[3] See SIB Principle 8; SIB Financial Supervision Rules 1990, Rule A; TSA Rules Ch. III (which apply until the SFA's harmonised financial rules which are the subject of consultation under SFA Board Notice No. 46 are finalised).

[4] See the example given by Professor Gower, *Review of Investor Protection - A Discussion Document* (January 1982), at para. 4.07.

[5] Multiple directorships should not normally give rise to conflict problems since a person who is a director of different companies would not be under an obligation to convey to one company information acquired in confidence from his position in another company; see para. 2.3.9, above; *Bowstead on Agency* (15th ed., 1985), at 412-420. The disclosure of such information could also be a criminal act: see Company Securities (Insider Dealing) Act 1985. Where the director discovers illegality in his position as director of a company which may be relevant to another company there is authority that he must make disclosure: see *Belmont Finance Corpn. Ltd.* v. *Williams Furniture Ltd. (No.2)* [1980] 1 All E.R. 393 at 404.

4.2.3 One of the suggested solutions for dealing with the conflicts that arise when an accountancy firm offers a range of other services to its audit customers[7] is the elimination of such conflicts by preventing firms from providing any additional services to their audit customers.[8] There have been objections to such an approach,[9] and many of the problems outlined above would also arise in the context of auditors. Other suggestions for the elimination of this problem have included the suggestion that fixed terms of appointment as an auditor should be introduced.[10]

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[6] The Law Society, *Fiduciary Duties and Regulatory Rules - Response to the Law Commission's Issues Questionnaire in relation to Solicitors* (Feb 1991), para. 24.4 ("However, the Society considers that the commercial interests of any organisation will break through separate corporate structures.").

[7] See para. 2.4.17, n. 86, above.

[8] See Social Security Committee, Second Report, *The Operation of Pension Funds* (March 1992), para. 147.

[9] See D.T.I. Consultative Document, *Regulation of Auditors: Implementation of the EC Eighth Company Law Directive*, para. 2.24.5.

[10] See D.T.I. Consultative Document, *op. cit.*, paras. 2.24.5, 2.24.8.

4.3 Specific Prohibition of Particular Types of Acute Conflict

4.3.1 It may be that certain conflicts give rise to such a serious degree of conflict that the only solution is to prohibit them *per se*.[11] Principle 6 of the SIB Statement of Principles recognises that "declining to act" may in certain circumstances be the appropriate way of dealing with a conflict of interest. For example, it might be considered that it would be improper in all but the most exceptional circumstances for a merchant bank to act for a bidder who is making a takeover bid for a former customer. No matter how the information relating to the former customer is isolated, for example, in what one respondent referred to as a "chinese cupboard",[12] it may simply not be possible to give the ex-customer the type of assurance to which it is undoubtedly entitled that the information would not be misused.[13] This type of outright prohibition is used to deal with solicitors acting for a client who has an adversarial relationship with a former client.[14] These solicitor disqualification cases are not on all fours with the position of financial conglomerates because of the added complication of lawyer-client privilege. An ex-client of a solicitor may be faced with the invidious decision that in order to show the improper disclosure of confidential information he will have to forfeit the solicitor client privilege.[15] This factor will not be present in dealing with conflicts in the context of financial conglomerates.

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[11] There may be other reasons for enforcing separation. For example, banks may be forbidden to carry on certain types of business in order to guarantee stability: see Dale, "International Financial Regulation : The Separation Issue" in Button and Swann, *The Age of Regulatory Reform* (1989), at 217.

[12] Files of the former customer would be placed under lock and key and would not be made available to anyone in the firm. Personnel who advised the ex-customer would also have to be isolated.

[13] For the views of the Panel on Take-Overs and Mergers on this see the announcement relating to *Tozer, Kemsley & Milbourn (Holdings) Plc ("Tozer")/Molins Plc ("Molins")*, 30 June 1987; *City Code on Take-Overs and Mergers*, Appendix 3.2. ("Financial Advisers and Conflicts of Interest": an adviser in a bid may have acted for the other party and it may not be possible to isolate the information relating to the other party and the adviser will have to decline to act). There is one poorly reported case where a financial adviser and his firm were enjoined by the target from acting for a bidder in a takeover because the adviser had previously advised the target when it was the subject of another bid (the *Charles Ball* case): see *Bank Confidentiality* (1990), (eds. Neate and McCormick), at 115.

[14] See *Lee (David) & Co. (Lincoln) Ltd. v. Coward Chance* [1991] Ch. 259; *Re a Firm of Solicitors* [1992] 1 All E.R. 353. These cases are dealt with in greater detail in para. 4.5.9, below.

4.3.2 The determination of the type of conflict that should potentially disqualify a firm from agreeing to act for a customer is not crystal clear. It seems that there must be a "significant possibility of conflict".[16] There will be certain types of conflict which will be de minimis. For example, the interest which a director has as a passive trustee would not trigger off the normal conflict of duty rules requiring a director to disclose an interest in a transaction in which the company was involved.[17] It is proposed to deal with the issue of declining to act first by dealing with the situation where a customer has not consented to the conflict and then with the situation where there is consent.

4.3.3 The type of situation in which it might be appropriate for a firm to decline to act under Principle 6 would, it is suggested, involve the following ingredients:

(i) knowledge[18] on the part of the firm that the conflict exists;

(ii) where there is a conflict between the duties a firm owes to different customers,[19] a reasonable apprehension on the part of a customer were he to know of the conflict, that his interests will be treated in a less favourable manner than the treatment accorded to some or all of the firm's other similarly situated customers;

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[15] See para. 4.5.11, below.

[16] *Chan v. Zacharia* (1983-84) 154 C.L.R. 178, 179. See further para. 2.4.9(i), above.

[17] *Cowan de Groot Properties Ltd v. Eagle Trust plc* [1991] B.C.L.C. 1045 at 1115. The situation is different if the director has more active duties: see *Transvaal Lands Co. v. New Belgium (Transvaal) Land and Development Co.* [1914] 2 Ch. 488.

[18] This knowledge could be actual or constructive in the sense that the firm should, as a prudent business firm, have had knowledge of it. If there are structures in place which prevent the attribution of knowledge to the relevant part of the firm (and these structures are held to be effective) there will be no obligation to decline to act since the firm is unaware of the conflict: see Core Rule 36(3), set out in Appendix 3.

[19] See para. 2.4.9(iii), above.

(iii) where there is a conflict between a firm's interest and that of its customer,[20] a reasonable apprehension on the part of the customer, were he to know of the conflict, that the firm would unfairly place its own interests above those of the customer.[21]

4.3.4 This sets a lower standard than that imposed by fiduciary law of primacy of the customer's interest. The Core Rules attempt to ensure fairness of treatment but do not ensure that the customer's interest is given priority.[22]

4.3.5 There are two subsidiary questions that need to be addressed with respect to the situation where a firm declines to act because of the nature of the conflict. The first relates to the possibility of a customer nevertheless agreeing to a firm continuing to act despite the conflict[23] and the second to the issue of whether a refusal to act could in itself constitute a breach of duty.

(i) Conflict and the role of consent: The question arises as to whether a conflict can be so acute that it is not possible for a customer who has been fully apprised of its nature to give his consent to the firm continuing to act on his behalf. This question has already been dealt with in paragraph 3.4.17 in dealing with the common law. Where the regulatory rules permit a firm to act in a situation of conflict but require client consent without further elaboration, the common law will be relevant in determining whether such consent has been given. The relevant regulatory rules may preclude a firm from entering into an agreement whereby a customer consents to an arrangement involving acute conflict. Where this is the case, there would be no mismatch between regulatory rules and fiduciary duties since the rules would be providing enhanced protection for the customer.

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[20] See para. 2.4.9(i), above.

[21] Under standard fiduciary rules once there is a conflict a beneficiary is entitled to any available remedy and there is no need for him to show that the underlying transaction was to his disadvantage. Our concern here is to determine what the provision for declining to act in the regulatory system obliges the firm to do. We have found little specific guidance as to when the "declining to act" principle comes into operation and the matter seems to be left to the judgment of the firm.

[22] Core Rules 20-27 and 1-4. These are set out in Appendix 3 and the latter are dealt with in greater detail in para. 4.4.1-4.4.2, below.

[23] This is dealt with in Section 3.4, above.

(ii) Declining to act as a breach of duty: This is a somewhat speculative issue but the point that it is intended to raise is whether it could ever be a breach of duty for a firm to *decline* to continue to act where it encounters a conflict which it considers necessitates such a course of conduct. This could only be an issue with respect to a relationship which already exists since refusing to take on a person as a new customer could not give rise to any liability.[24] Thus, what we are concerned with is whether a refusal to continue to act can constitute a breach of duty. There may well be situations where a firm is already acting for a customer and it transpires in a way that it did not foresee when the relationship was first entered into that it is unable to continue to act either because of a conflict of duty or a conflict of interest. If the firm could not refuse to act in this situation it would be faced with the invidious choice of acting and being in breach of duty, or refusing to act and equally being in breach. While we found no authority on this, as a matter of principle it is difficult to see how in this situation it would be a breach of duty to refuse to continue to act.[25] Where the conflict was foreseeable at the time the relationship between the firm and the customer was entered into, or where the firm decides to act for a new customer which creates the conflict precipitating the decision not to act for its existing customer, the position is uncertain. Refusing to act in situations where the customer is entitled to expect continued service from the firm may constitute a breach of duty. In such situations the firm could protect itself by a suitably drafted customer agreement entitling it to discontinue to act in a situation of conflict. But, since these situations of foreseeable conflict, or the voluntary creation of conflict, are within a firm's control, it is the responsibility of the firm, where they give rise to legal or regulatory problems, to avoid them, even if this involves elaborate internal arrangements.

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[24] English law in the context of commercial relationships normally does not oblige a person to enter into a commercial relationship.

[25] A fiduciary must not put himself in a position where he has conflicting duties: *Moody* v. *Cox and Hatt* [1917] 2 Ch. 71; *Bowstead on Agency* (15th ed., 1985), at 188-189; Finn, *Fiduciary Obligations* (1977), Ch. 22; para. 2.4.9(iii), above, and if he does he may incur liability. This is not the problem under discussion which is that of subsequently declining to act.

4.4 Independence

4.4.1 The principle of independence is designed to ensure that the firm acts in a professional manner and subordinates its own interests to those of its customers. It is reflected in a number of Core Rules and in the scope of the rules of SROs for firms to set up their own independence policies.[26] The requirements of independence are to be found mainly, although not exclusively, in Core Rules 1-4[27] which seek to protect the interests of a customer by: (a) prohibiting a firm from taking or giving inducements[28] which would significantly conflict with the duties that the firm owes to the customer;[29] (b) requiring a firm to take reasonable steps to ensure fair treatment of a customer where the firm is dealing with the customer in an advisory or discretionary capacity with respect to a transaction in which it has a material interest;[30] (c) regulating soft commissions in the case of an advisory or discretionary customer by requiring disclosure, best execution on the part of the broker through whom the firm deals, and the prohibition of the payment of soft commission to market makers;[31] (d) in the case of advice to private customers about packaged products,[32] a firm must be a product company or an independent intermediary and, if the former, can only recommend its own product.[33] Another example of independence is the rules of the Takeover Panel on exempt fund managers and exempt market makers who must apply to the Panel for exemption so that they will not be treated as a concert party to the firm with which they are connected.[34] The matters that have to be covered in an application for exempt fund manager (EFM) status cover inter alia:

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[26] For example, SFA Rule 5-29(2).

[27] Set out in Appendix 3. See Blair, *Financial Services The New Core Rules* (1991), ch. 5.

[28] "Inducement" is defined to exclude inter alia a disclosable commission: see the Financial Services Glossary 1991 (2nd ed.), (set out in Appendix 3). On commissions see SIB Retail Regulation Review, Discussion Paper 3, *Disclosure* (October 1991); SIB Retail Regulation Review, Consultative Paper 60, *Disclosure, Polarisation, and Standards of Advice* (March 1992). See also SFA Rule, 5-7.

[29] Core Rule 1.

[30] Core Rule 2 and the Financial Services Glossary 1991 (2nd ed.), set out in Appendix 3. See also SFA Rule 5-29.

(i) the physical location of the EFM vis-à-vis other members of the group,

(ii) common directorships between the EFM and the other members of the group,

(iii) present Chinese wall procedures including any internal rules and regulations,

(iv) details of the shared services between the EFM and the group, for example, the sharing of a library or a research department,

(v) information flows within the group, and

(vi) details of practices relating to the acceptance on behalf of managed funds of offers of securities in which the group corporate finance arm is acting.

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[31] Core Rule 3. See also SFA Rule 5-8.

[32] Defined in the Financial Services Glossary 1991 (2nd ed.), set out in Appendix 3.

[33] Core Rule 4. See also Core Rule 17 (standards of advice on packaged products) set out in Appendix 3; SFA Rules 5-19 and 5-20. This policy is referred to as "polarisation": see SIB, Retail Regulation Review, Discussion Paper 3, *Polarisation* (October 1991); SIB Retail Regulation Review, Consultative Paper 60, *Disclosure, Polarisation, and Standards of Advice* (March 1992), at 15-17.

[34] The City Code on Take-Overs and Mergers, Rule 7.2. For the definition of "exempt fund manager" and "exempt market maker" see the definition section of the City Code on Take-Overs and Mergers; *Weinberg and Blank on Take-Overs and Mergers* (5th ed., 1989), paras. 3-709-3-713. See Panel on Take-overs and Mergers, *Multi-Service Financial Organisations and the Take-Over Code* (1986/34).

4.4.2 Requirements of independence and independence policies do not necessarily eliminate conflict.[35] Their effect is to manage such conflict by requiring a firm to which they apply to give priority to the interests of the customer. For example, Core Rule 2 clearly recognises that there may be a conflict of interest and where this occurs the firm must take reasonable steps "to ensure fair treatment for the customer". This is a departure from the fiduciary norms which apply irrespective of the fairness of the transaction - once there is a conflict the fiduciary rules apply and it is not for the fiduciary to argue that the transaction was fair, that he acted in good faith, or that the customer was treated fairly.[36]

4.5 Chinese Walls

4.5.1 The favoured technique for dealing with many conflicts arising from the carrying on of financial business in a conglomerate is the use of Chinese walls.[37] Broadly, Chinese walls are procedures for restricting information flows within a firm to ensure that information which is confidential to one department is not improperly communicated (and this includes inadvertent communication) to any other department within the conglomerate.[38] The purpose of a Chinese wall is to prevent the attribution of knowledge between the component parts of a firm on different sides of the wall. It has been argued that this does not provide complete protection to a fiduciary in a conflict situation since, where there is conflict, the vice is not the possibility of the misuse of information but rather the "compromising of a fiduciary's duty of loyalty."[39] Up to a point this is true. However, protection would be provided against any allegation of breach of the duty of loyalty where the customer consents to the firm carrying on business using a Chinese wall as part of its organisational structure.[40] In this situation the context of the duty of loyalty would be determined by the arrangement between the firm and the customer and would be adjusted to reflect the fact that the firm would act for its customer in a context where information held by part of the firm was not known to other parts of the firm because of the wall.

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[35] See SFA Rule 5-29 which requires the firm's employee to disregard the firm's material interest or conflict of interest. The Guidance Notes recognise that policies of independence may not suffice in all situations and may have to be accompanied by other steps such as specific disclosure. Rule 5-29(3) requires in the case of private customers that a firm disclose in writing that there may be a conflict of interest and also the existence of the independence policy. See para. 3.4.32, below.

[36] See *Armstrong v. Jackson* [1917] 2 K.B. 822 at 824 - a broker/customer case ("It matters not that the broker sells at the market price, or that he acts without intent to defraud ... The Court will not enter into discussion as to the propriety of the price charged by the broker, nor is it material to inquire whether the principal has or has not suffered a loss.").

[37] For the position of the SEC on the use of Chinese walls see *Koppers Co. v. American Express Co.* 689 F. Supp. 1371 (W.D.P.A. 1988) (the SEC considers that conflicts arising from multi-service financial conglomerates can be avoided by well-established preventative policies and procedures such as Chinese walls).

[38] See "Draft Code of Conduct on the Management of Conflicts of Interest", in The Council for the Securities Industry, *Report on the Year Ended 31st March, 1985*, at 20.

4.5.2 The responses to our Issues Questionnaire indicated that Chinese walls are very widely used in organisations offering financial services.[41] Also, from the replies of respondents, it would appear that solicitors and accountants need to make use of Chinese walls less frequently: in the case of the solicitors this was no doubt due to the Law Society's almost total prohibition on solicitors acting in a conflict of duty or a conflict of interest situation.[42] The erection and operation of Chinese walls normally involves some combination of the following organisational arrangements:[43]

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[39] Finn, "Fiduciary Law and the Modern Commercial World", Norton Rose Oxford Law Colloquium (1991), at 13. A similar point is made in *Financial Services in the United Kingdom: A New Framework for Investor Protection* (1985), Cmnd. 9432, at para. 7.4, on which see para. 5.3.3 below.

[40] See paras. 3.4.29-3.4.31, above.

[41] See Appendix 1. As many of our consultees pointed out, this was also the case in connection with the Prevention of Fraud (Investments) Act 1958: see The Licensed Dealers (Conduct of Business) Rules S.I. 1983/585, para. 2 (the definition section) and para. 8(2)(a) (the provision giving effect to the Chinese wall).

[42] See paras. 5.3.32-5.3.33, below and The Law Society, *Fiduciary Duties and Regulatory Rules - Response to the Law Commission's Issues Questionnaire in relation to Solicitors* (February 1991). On solicitors see paras. 4.5.7-4.5.10, below.

[43] Core Rule 36 which deals with Chinese walls and which is discussed in greater detail in paras. 4.5.12 and 4.5.13, below and set out in Appendix 3, requires an "established arrangement". Also Principle 9 requires a firm to have "well-defined compliance procedures". For the general treatment of Chinese walls see: Rider, "The Fiduciary and the Frying Pan", [1978] Conv. 114; Rider, *Insider Trading*(1983), ch. 5; Poser, "Chinese Wall or Emperor's New Clothes?", (1988) 9 Comp. Law. 119, 159, 203; Suter, *The Regulation of Insider Dealing in Britain* (1989), at 307-311; Hannigan, *Insider Dealing*, at 144-148.

(i) the physical separation of the various departments in order to insulate them from each other - This often extends to such matters of detail as dining arrangements;

(ii) an educational programme,[44] normally recurring, to emphasise the importance of not improperly or inadvertently divulging confidential information;

(iii) strict and carefully defined procedures for dealing with a situation where it is felt that the wall should be crossed and the maintaining of proper records where this occurs;[45]

(iv) monitoring by compliance officers of the effectiveness of the wall which would normally include the monitoring of employee trading;[46]

(v) disciplinary sanctions where there has been an improper breach of the wall.

4.5.3 Before examining the current regulatory framework for the creation of Chinese walls, it is proposed firstly to examine briefly the use of Chinese walls in other jurisdictions and secondly to analyse their effectiveness in the law firm context. The reasons for this latter examination is that this is the only area in which the effect of the Chinese wall has been examined by the courts in any significant depth, although, as will be pointed out, these cases may not be apposite for other customer-professional relationships where the Chinese wall is used.

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[44] Core Rule 34 (set out in Appendix 3) requires a firm to establish procedures to ensure that its officers and employees act in conformity with their employer's and their own responsibilities under the regulatory system. Procedures must also be established to ensure that there is compliance with any prohibition on insider trading. See also SFA Rule 5-51.

[45] Core Rule 34(2) (set out in Appendix 3) obliges a company to maintain records of its compliance with the regulatory system. See also SFA Rule 5-54.

[46] See SFA Rule 5-51(2) and (7) (personal account notice); Rule 5-53 (compliance review).

Other Jurisdictions

4.5.4 Other jurisdictions use the Chinese wall as a technique for dealing with conflicts in financial conglomerates and their structure is broadly similar to that set out in paragraph 4.5.2.[47] For example, section 1002M of the Australian Corporations Law 1990 provides that a body corporate is not precluded from entering into a transaction at any time merely because of information in the possession of an officer of that body corporate if:

> "(a) the decision to enter into the transaction or agreement was taken on its behalf by a person or persons other than [the] officer [with the information];
>
> (b) it had in operation at that time arrangements that could reasonably be expected to ensure that the information was not communicated to the person or persons who made the decision and that no advice with respect to the transaction or agreement was given to that person by a person in possession of the information; and
>
> (c) the information was not so communicated and no such advice was so given."[48]

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[47] See generally Poser, "Chinese Walls or Emperor's New Clothes?", (1988) 9 Comp. Law. 119, 159, 203; Poser, *International Securities Regulation* (1991), at 183-251 (hereafter "Poser"); A Report by the Division of Market Regulation, SEC, *Broker-Dealer Policies and Procedures Designed to Segment the Flow and Prevent the Misuse of Material Nonpublic Information* (March 1990). Even where the Chinese wall is primarily directed at insider trading it will probably have the characteristics set out in para. 4.5.2, above.

[48] This was originally section 1002(7) of the Corporations Act 1989 but was renumbered by reforms introduced in 1991 (see Corporations Legislation Amendment Act 1991). For predecessor legislation, see s. 128 (7) of the Australian Securities Industry Act 1980; Ford, *Principles of Company Law* (4th ed., 1986), at 716-721. It would appear that the arrangements to prevent the improper communication of information can include a provision in a company's articles for the withdrawal from a directors' meeting of any director who has inside information (Ford, *op. cit.*, at 720, n.63).

Reforms introduced in 1991 extend a somewhat similar provision to partnerships.[49] Other jurisdictions with developed financial markets also rely on Chinese walls as a regulatory device.[50]

4.5.5 The jurisdictions that appear to have the most extended experience with Chinese walls are in the United States and there they have obtained widespread recognition as a means of dealing with conflicts within financial conglomerates.[51] The various regulatory authorities (both self-regulatory and public) have given their imprimatur of approval to their use and endorsed their effectiveness.[52] The Chinese wall is also recognised in American legislation dealing with the control of the financial markets. For example, the rules passed under the Williams Act 1968[53] make it illegal for a person, who has acquired non-public information about a pending takeover bid from either the bidder or the target company, to trade in the shares of the target company. However, this prohibition does not apply to a firm where the individual making the investment decision does not know of the confidential information and the firm has, inter alia, put in place procedures to ensure that the individual entering into the transaction does not have knowledge of the non-public information relating to the bid.[54] This provision protects against liability created by the statute itself and is not explicitly aimed at any common law liability. Somewhat similarly, the Insider Trading and Securities Fraud

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[49] S. 1002N of the Corporations Law 1990.

[50] For Canada see Securities Act Regulations (Ontario), RRO 1980 (as amended), reg. 156d; National Policy Statement - *Guidelines for the Establishment of Procedures in Relation to Confidential Information*; Yontef, "Insider Trading - Lawyers and Accountants", in *Securities Law* (Law Society of Upper Canada, 1989), at 247; for New Zealand see Securities Amendment Act 1988, s. 8(3); Quinn, "The Securities Amendment Act and the Chinese Wall" (1989), 7 Otago L. Rev. 141.

[51] Most of the relevant literature and authorities are to be found in Vann, "The Multi-Service Securities Firm and the Chinese Wall: A New Look in the Light of the Federal Securities Code", (1984) 63 Neb. L. Rev. 197. As Vann points out, the American Law Institute's proposed Securities Code contains a Chinese wall provision: see *op. cit.*, n. 149 and pp. 242-246.

[52] The Chinese wall procedure is recognised by the New York Stock Exchange and the American Stock Exchange; see Poser, *op. cit.*, at 210-212.

[53] This refers to the reforms of the Securities Act 1934 designed to regulate takeovers: for a convenient analysis see Loss, *Fundamentals of Securities Regulation* (1988), at 568 *et seq.* The relevant rule discussed in the commentary is Rule 14e-3, C.F.R., section 240 (1991 Supp.).

[54] See Poser, *op. cit.*, at 205-206.

Enforcement Act 1988[55] requires firms to establish procedures to prevent market abuses among which is the improper use of confidential information. In connection with this the SEC, which has the responsibility for enforcing the Act, considered that the "minimum elements" necessary to establish an effective Chinese wall would:

> "include the review of employee proprietary trading memorialization and documentation of firm procedures, substantive supervision of inter-departmental communication by the firm's compliance department, and procedures concerning proprietary trading when the firm is in possession of material non-public information".[56]

With respect to other aspects of its regulatory responsibilities, the SEC has endorsed the use of Chinese walls as a technique for dealing with the improper use of confidential information.[57]

4.5.6 There is general agreement among the commentators in the United States that Chinese walls will in some circumstances operate to prevent knowledge being attributed from one part of the firm to another. Thus, for example, there is a consensus that a firm which has created a wall would not be liable for insider trading if at the time its brokers were trading in shares another part of the firm was in possession of material, confidential inside information concerning those shares.[58] However, there is less agreement on whether a Chinese wall will protect a firm where it recommends to its customers a security which information in the possession of the firm indicates to be ill advised, or where a firm is trading on its own account at a time when one part of the firm is in possession of confidential information relating to that security. Some take the view that in these situations the firm should adopt a policy of not recommending the security or not trading on its own account.[59]

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[55] Poser, *op. cit.*, at 209, who points out that this Act leaves unchanged the existing law on fiduciary obligations.

[56] See National Association of Securities Dealers and the New York Stock Exchange, Notice to Members, 21 June 1991. The New York Stock Exchange has established its own rules requiring a regular review by its members of employee and proprietary trades to identify violations of the Securities Exchange Act 1934 (NYSE rule 342.21(a)). See Miller, "Self-regulatory Organizations and the Securities Industry: Does Membership have its Privileges?", (1991) 19 Sec.Reg.L.J. 3.

[57] See *Koppers Co. Inc. v. American Express Co.* 689 F. Supp. 1413 (1988) statement of general counsel to the SEC endorsing the use of Chinese walls.

[58] To avoid liability for insider training is one of the prime reasons for the creation of the Chinese wall in the United States. This is not a significant problem under the Company Securities (Insider Dealing) Act 1985 (as amended by the FSA, s. 174) since liability is imposed on individuals who have price sensitive information because of their relationship with the company. By concentrating on the individual there is little scope for the principle of attribution to operate. There are also

Law Firm Disqualification Cases

4.5.7 There has been a number of recent cases dealing with the situation where a firm of solicitors finds itself in a position in which it is advising a client who has an adversarial relationship with a former client.[60] In some of these cases the courts have examined the effectiveness of a Chinese wall as a device for permitting the firm to continue to act for its new client but nevertheless protecting the interests of its former client against having confidential information disclosed to his prejudice. The overall result of these cases, both in the United Kingdom and various Commonwealth countries, is that the Chinese wall has not been seen as providing satisfactory protection for the interests of the former client and, despite the existence of a Chinese wall, the courts have required the law firms not to act on behalf of the new client.

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specific exemptions in the Act to deal with the situation where an individual might be held to be trading on the basis of price sensitive information: see s. 3(1)(d), (2) and s. 9. See also SFA Rule 5-46.

[59] See Lipton and Mazur, "The Chinese Wall Solution to the Conflict Problems of Securities Firms", (1975) 50 N.Y.U.L.R. 459; Chazen, "Reinforcing the Chinese Wall: A Response", (1976) 51 N.Y.U.L.R. 552; Lipton and Mazur, "The Chinese Wall: A Reply to Chazen" (1976) 51 N.Y.U.L.R. 579. See *Slade v. Shearson Hammill & Co. Inc.* 517 F. 2d 398 (2d Circ. 1974) in which the SEC argued that a firm should not recommend a share where information in its possession showed the investment to be ill advised.

[60] These cases have often arisen from law firm amalgamation. For the rules of The Law Society which prohibit a solicitor from acting where there is a conflict between the interests of clients or between a client and an ex-client, see paras. 5.3.32-5.3.33, below.

4.5.8 The starting point for an analysis of when it is improper for a solicitor to act against a former client is the Court of Appeal decision in *Rakusen* v. *Ellis, Munday & Clarke*[61] which for over half a century has been the leading authority on the matter. R had consulted M, a solicitor, in connection with a wrongful dismissal claim that he had against his former employer. R changed solicitors and the dispute with his former employer was referred to arbitration. In the arbitration, C, M's only partner, was retained by R's former employer and the retainer was entered into in the name of the firm. R sought an injunction to restrain the firm from acting for his ex-employer. Warrington J.'s decision in favour of R was reversed by the Court of Appeal which held that there was no general rule that a solicitor could not act against an ex-client in subsequent litigation. However, the solicitor could not use information acquired as a result of the relationship with his former client to further the interests of his new clients, and where there was a "risk" that this would occur he would be enjoined from acting for the new client. In deciding what was the standard to be applied in assessing the existence of the risk of improper disclosure the court in *Rakusen* did not speak with a single voice: "[t]here is a considerable difference of emphasis and degree in those judgments".[62] Cozens-Hardy M.R. considered that the court "must be satisfied that real mischief and real prejudice will in all human probability result if the solicitor is allowed to act."[63] Fletcher Moulton L.J. stated that the court should only intervene "where mischief is rightly anticipated" which requires "such a probability of mischief that the Court feels that ... it ought to interfere".[64] Lastly, Buckley LJ considered that a solicitor would be restrained from acting against a former client where "there exists, or ... may exist, or may be reasonably anticipated to exist, a danger"[65] that the solicitor will communicate confidential information acquired from the former client to the new client. On the facts the court was satisfied that there was no risk to R since M and C carried on virtually separate practices and there was an undertaking offered that C, and not the firm, would act as the solicitor of record.[66] The court in assessing the risk of prejudice concentrated on the dangers of express communication of information and did not direct its analysis to more indirect or inadvertent ways in which information can be communicated.[67]

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[61] [1912] 1 Ch. 831.

[62] *Re a Firm of Solicitors* [1992] 1 All E.R. 353, 366 *per* Staughton L.J.

[63] [1912] 1 Ch. 831, 835.

[64] [1912] 1 Ch. 831, 841.

[65] [1912] 1 Ch. 831, 845.

4.5.9 In a trilogy of recent cases *Rakusen* has been the subject of reassessment. The cases in chronological order are *Re a Solicitor*[68], *Lee (David) & Co. (Lincoln) Ltd.* v. *Coward Chance*[69] and *Re a Firm of Solicitors.*[70] Their effect is to confine *Rakusen* to its special facts and cast considerable doubt on the efficacy of Chinese walls where a solicitors' firm acts for a client with conflicting interests to those of a former or an existing client.

(i) *Re a Solicitor*: This is the least significant of the cases. Hoffmann J cited the dictum of Cozens Hardy M.R. in *Rakusen* but it was unnecessary for him to analyse the judgments in that case in any great depth since he found in the instant case that the relationship between the client and the solicitor could not have resulted in the communication of any confidential information that would be relevant to the action with respect to which the solicitors were acting against the ex-client. Since there was an absence of confidential information there was a fortiori an absence of any risk to the client.

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[66] The reporter reports that no undertaking was in fact directed (at p. 845). In *Re a Firm of Solicitors* [1992] 1 All E.R. 353 Parker L.J. considered that the court in *Rakusen* reached its decision on the basis of the undertaking and but for the undertaking "it would have reached a different conclusion" (at p. 360), cf. Staughton L.J.

[67] For a description of this type of communication see *D & J Constructions Pty. Ltd.* v. *Head* (1987) 9 N.S.W.L.R. 118, 123 : "... wordless communication can take place inadvertently and without explicit expression, by attitudes, facial expression or even avoiding people one is accustomed to see, even by people who sincerely intend to conform to control".

[68] (1987) 131 S.J. 1063 (31 March 1987).

[69] [1991] Ch. 259.

[70] [1992] 1 All E.R. 353.

(ii) *Lee (David) & Co. (Lincoln) Ltd.* v. *Coward Chance*: The conflict in this case arose from the merger of two firms of solicitors. One firm was acting for liquidators and the other had acted for a firm of accountants against whom the liquidators were bringing an action alleging fraud. The liquidators wanted to retain the services of the merged firm but the accountants objected. Browne-Wilkinson V-C considered that what the court should look for was "whether mischief was rightly anticipated" by the ex-client that confidential information would be improperly communicated.[71] In *Lee (David) & Co. (Lincoln) Ltd. v. Coward Chance* it was clear, given the gravity of the charges made against the accountants, that confidential information would undoubtedly have been communicated to the solicitors. The Vice-Chancellor accepted that the partners of the firm would not consciously divulge any confidential information, but this did not address the whole problem since it was also necessary to deal with the element of "seepage" of the information "through casual chatter and discussion" and the revealing of seemingly innocuous information which might subsequently prove of importance "as a link in a chain of causation or reasoning".[72] Although the firm had erected a Chinese wall, the court was not satisfied that "there is not a real risk of leakage" of information[73] particularly in connection with the staff (as opposed to the partners) with respect to whom no serious steps had been taken to ensure that the information would remain confidential.

(iii) *Re a Firm of Solicitors*: In *Lee (David) & Co. (Lincoln) Ltd.* v. *Coward Chance* there was only meagre evidence as to the creation and structure of the Chinese wall. The same cannot be said of the final case of the trilogy where there was evidence of a determined attempt to create a leak proof wall.

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[71] [1991] Ch. 259, 267.

[72] [1991] Ch.259, 268.

[73] At 270. Browne-Wilkinson V-C stated that by this double negative formulation he did not intend to reverse the normal burden of proof but rather that "prima facie in a firm information does move" (*ibid*). However, with this presumption the firm will inevitably have to prove that there is no risk to the client; cf. *Martin v. MacDonald Estate (Gray)* [1991] 1 W.W.R. 705 (S.C.C.).

Nevertheless, the court held that it did not protect the firm against disqualification. *Re a Firm of Solicitors* involved a company within a group successfully preventing ex-solicitors to another company within the group from acting for a former employee in an action it was bringing against him.[74] In deciding whether there was a risk that confidential information, which had undoubtedly been disclosed, might be improperly leaked Parker L.J. held that the proper test was "whether a reasonable man informed of the facts might reasonably anticipate" that the confidential information would be improperly communicated.[75] Sir David Croom-Johnson concurred with Parker L.J. but Staughton L.J. dissented. Both Parker L.J. and Sir David Croom-Johnson were concerned not so much with the deliberate communication of confidential information but rather with the danger posed by the "chance remark" or the "inadvertent" risk of leaking the information. If this concern with the inadvertent communication of information is coupled with a prima facie presumption that within a firm information does move,[76] and the court's concern is also to preclude the communication of apparently innocuous but subsequently significant information, the conclusion of Parker L.J. in *Re a Firm of Solicitors* that it was to be doubted whether " an impregnable wall can ever be created" except in "very special cases"[77] is virtually inevitable.

4.5.10 A similar, if not a more profound scepticism, and sometimes an outright rejection, of the efficacy of Chinese walls to manage lawyer-client conflicts has been evinced by Courts in other Commonwealth jurisdictions.[78] *Rakusen* itself has been heavily criticised and, in some cases, a more demanding hurdle has been set before a law firm can successfully avoid disqualification where it is acting in a matter against a former client. For example, in *Martin v. MacDonald Estate (Gray)*[79] the Supreme Court of Canada rejected the "probability of mischief" standard and replaced it with two rebuttable presumptions: (a) a presumption that confidential information will be communicated by the client in the course of the retainer. The burden of discharging this presumption would be on the firm and would be a "difficult burden to discharge;"[80] and (b) a presumption that lawyers who work together share confidences. This could only be rebutted by "clear and convincing evidence".[81]

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[74] Although the firm had not been the solicitor to the company bringing the action against the former employee, the court found that confidential information had been communicated and the normal solicitor-client rules should apply.

[75] At 362. In adopting this test, Parker L.J. rejected the test of Cozens-Hardy M.R. in *Rakusen* as setting too demanding a standard for the ex-client to satisfy and saw his test as having similarities to that of Fletcher Moulton L.J. in *Rakusen*.

[76] *Lee (David) & Co. (Lincoln) Ltd.* v. *Coward Chance* [1991] Ch. 259, 270 ("prima facie in a firm information does move").

[77] At 363.

Relevance of the Law Firm Disqualification Cases for Other Areas in Which Chinese Walls are used

4.5.11 There are a number of factors present in the lawyer-client relationship that have led to doubts about the efficacy or the acceptability of the Chinese wall to manage situations of conflict. Some of these are unique to the lawyer-client relationship but others are of a more general application. The factors that have influenced the courts against permitting a solicitors' firm to rely on the Chinese wall are:

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[78] See *D & J Constructions Pty. Ltd.* v. *Head* (1987) 9 N.S.W.L.R. 118, 122-123; *Mallesons Stephen Jacques* v. *KPMG Peat Marwick* (Supreme Court of Western Australia, 19 Oct. 1990, Ipp J. "... I consider that the consequences of a firm of solicitors placing itself in a conflict of interest situation cannot be avoided by some partners undertaking not to disclose information to others"); *Kupe Group Ltd.* v. *Auckland City Council* (1989) 2 P.R.N.Z. 60; *McNaughton* v. *Tauranga County Council (No. 2)* [1987] 12 N.Z.T.P.A. 429; *National Mutual Holdings Pty. Ltd.* v. *Sentry Corp* (1989) 87 A.L.R. 539, 558-561 where the views expressed by Gummow J. were antipathetic to *Rakusen*. The Canadian Supreme Court has held that a court would only accept the efficacy of Chinese walls in the most exceptional circumstances at least until the governing bodies of the legal profession had approved of their use: *Martin* v. *MacDonald Estate (Gray)* [1991] 1 W.W.R. 705, 726.

[79] [1991] 1 W.W.R. 705.

[80] *Ibid.*, 724-725.

[81] *Ibid.*, 726.

(i) the court's entitlement to demand the highest ethical standards from its officers;[82]

(ii) the need for the public to have confidence in the integrity of the legal profession;

(iii) the need to protect the client from the possible subsequent embarrassment of the solicitor when acting in a potential conflict situation which might oblige the solicitor to withdraw from the case and perhaps cause expense to the client;

(iv) the ease with which information can unwittingly be communicated;

(v) the difficulty of accurately identifying what information is of importance because this will often only be determined subsequently by the evolution of future unforeseen events;

(vi) the fact that a client in order to prove breach of confidence may be forced to forfeit the lawyer-client privilege.[83]

A number of these factors will be present in conflict situations in the other relationships covered in this Consultation Paper. But factors (i), (ii) and, in particular, (vi) are unique to the lawyer-client relationship and are of sufficient weight that the reasoning in the lawyer-client cases cannot be transferred automatically to the other relationships. Also of importance are the rules of the Law Society which for all intents and purposes prohibit absolutely a solicitor from acting for clients who have conflicting interests and provide for the Chinese wall to play only a very limited role with the client's consent in situations where law firms amalgamate.[84] This factor of course distinguishes solicitors from the other professions under consideration in this Paper since the rules of the latter permit conflict which is managed by means of the Chinese wall.

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[82] Gurry, *Breach of Confidence* (1984), at 150 questions whether it makes sense to talk in terms of a higher duty of confidence - a duty of confidence is a duty of confidence.

[83] There are factors going the other way, for example, a person's entitlement to retain the lawyer of his choice and saving of costs if disqualification is refused at a point where a solicitor has run up substantial fees.

Core Conduct of Business Rule 36

4.5.12 Core Rule 36[85] is a piece of subordinate legislation which specifically recognises the validity of Chinese walls as a means of restricting the attribution of knowledge to one part of a firm from another.[86] It applies where a firm "maintains an established arrangement which requires information obtained by the firm in the course of carrying on one part of its business of any kind to be withheld in certain circumstances from persons with whom it deals in the course of carrying on another part of its business of any kind". There is no definition of what constitutes an "established arrangement" but it would appear to involve the type of arrangement set out in paragraph 4.5.2, above.[87] The rules of the various SROs also provide for the creation of Chinese walls.[88]

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[84] See paras. 5.3.32-5.3.33, below. Sir David Croom-Johnson considered these rules to be "persuasive" in *Re a Firm of Solicitors* (1987) 131 S.J. 1063, and in *Lee (David) & Co. (Linclon) Ltd. v. Coward Chance* [1991] Ch. 259, 266 Browne-Wilkinson V.-C. considered them to be "sensible and good".

[85] Set out in Appendix 3. See further paras. 5.3.16-5.3.22, below.

[86] See also SFA Rule 5-3. Rule 5-3(1) refers to an "established *and effective*" arrangement. It is to be doubted if the adjective "effective" adds much since an ineffective wall would not satisfy the requirements of Core Rule 36(1). There is a definition of Chinese wall in the Financial Services (Glossary and Interpretation) Rules and Regulations 1990 but no similar definition in the Financial Services Glossary 1991 (2nd ed.). The reason for the omission would appear to be the extended treatment of Chinese walls in Core Rule 36.

[87] It has been argued that Core Rule 36 is not the type of rule contemplated by ss. 47 and 48 of the FSA because it lacks substantive requirements: see Berg, "Chinese Walls Come Tumbling Down", [1991] I.F.L.R., 23 at 26. This is difficult to accept. The *purpose* of the "established arrangement" is clear and leaving the mechanics of implementation to those affected can scarcely vitiate the rule on the grounds of vagueness; see *McEldowney v. Forde* [1971] A.C. 632 and para. 5.4.21, below.

[88] See, for example, SFA Rule 5-3, IMRO Chap. I. Rule 4.2.

4.5.13 The manner in which Core Rule 36 recognises the validity of Chinese walls attempts to accord protection to a firm which establishes a wall without the need to obtain the consent of the customer where information has not passed across a wall. Rule 36(1) clearly assumes that when a firm establishes a Chinese wall the information can be withheld and will therefore not be attributed in the circumstances covered by the rule. The protective shield that it creates is not dependent on customer consent[89] but on the fact that the information is withheld pursuant to an established arrangement. Obviously, however, the assurance of protection will be enhanced by the customer's consent to its operation. In addition, there appears to be no obligation on the part of the firm to inform the customer of the existence[90] of a Chinese wall although it may be that the terms in the customer agreement, for example, permitting the firm to withhold confidential information obtained from another customer,[91] indirectly achieve this effect.

4.5.14 Two issues arise with respect to Chinese walls. First, are they effective at common law to preclude a firm from being held to be in breach of duty to its customer? Such alleged breach could take the form of failing to disclose to the customer confidential information that is relevant to the customer's interests or a conflict of interest between the interests of the firm and the interests of the customer. Secondly, to what extent does the fact that Chinese walls have a certain degree of statutory underpinning have a bearing on the first issue? This latter question is dealt with in Part V and, of course, it only arises if Chinese walls fail to provide adequate protection at common law. Also, it is important to bear in mind that the question of the effectiveness of Chinese walls only arises if, although there is no actual knowledge, information held by one part of the firm is attributed to another part; if a firm does not "know" then there can be no breach of duty. The issue of attribution has already been dealt with in Section 2.3. For the purpose of the following discussion it will be assumed that without the existence of the Chinese wall the information held in one part of the firm will be attributed to another part where the information is relevant to the discharge by the latter of its functions and vice versa.

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[89] For an example of a clear conferral of protection by a Chinese wall see Clause 14 of the Companies Bill 1973 set out in Appendix 2, below.

[90] Cf. independence policies (as to which see paras. 4.4.1-4.4.2, above) which have to be disclosed to private customers.

[91] See paras. 3.4.30-3.4.31, above.

4.5.15 It is proposed to deal with the effectiveness under the general law of Chinese walls which remain intact in two separate situations. The first is where the customer is aware of the existence of the Chinese wall and consents to the firm handling his affairs on the basis that the wall will staunch information flows within the firm. The second is where a Chinese wall has been established but the customer is unaware of its existence. The latter situation is affected by the extent to which custom can be invoked to affect the relationship between a customer and a firm.[92] It will be assumed for present purposes that custom would not give effect to a Chinese wall arrangement between firm and customer where its existence had not been communicated to the customer.

4.5.16 As regards the first situation, adequate consent and disclosure in a conflict of duty situation should result in the Chinese wall providing protection to the conglomerate. This would be particularly so where the release of information is legally prohibited, for example, by the Company Securities (Insider Dealing) Act 1985. The same result should pertain where there is a conflict of interest. As we have seen in Section 3.4, a customer can consent to the firm dealing in a situation where there is a conflict of interest provided the requirements of adequate disclosure and consent have been satisfied. However, the difficulties encountered in making sufficient disclosure mean that disclosure and consent cannot be relied upon to provide protection.

4.5.17 Where there is no consent, or disclosure is insufficient, the issue is more problematical as to whether (if, contrary to our provisional view, Rule 36 does not provide protection because of its public law status)[93] a firm is protected where it has established a

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[92] See Section 3.2, above.

[93] As to which see paras. 5.3.16-5.3.21, below.

Chinese wall structure. A customer has every expectation that a firm advising him will use all the information in its possession to further his interests. Where disclosure of the information would be a criminal act a strong argument can be made that the customer cannot expect its adviser to commit a crime for the furtherance of his interests. Whatever obligations a firm has to a customer to make use of information which is in its possession, it is difficult to see how this obligation could oblige a firm to commit a criminal act. But even this situation is not crystal clear, since, if the adviser does not obtain the consent of the customer and make adequate disclosure of the Chinese wall policy, it is arguable that the firm should refuse to act and thus avoid conflict. Where disclosure would be a breach of confidence to the first customer but not a criminal act, the second customer would have an argument that in the absence of consent there is no compelling reason why his interests should be deferred to those of the first customer. Likewise, the first customer would legitimately expect that his interests will be protected by not disclosing confidential information pertaining to his affairs. The position with respect to these conflicting duties is far from clear.[94]

4.5.18 In a conflict of interest situation the position is even more uncertain. The American case of *Black* v. *Shearson, Hammill & Co.*[95] illustrates how this problem could arise. In that case the defendant investment house was recommending the purchase of shares in a company at a time when one of the defendant's senior managers had acquired inside information, as a director and principal financial adviser of the company, showing that the company was in financial difficulty. The senior manager had been encouraging the firm's salesmen to purchase the shares of the company on behalf of customers. At the time the salesmen were making the purchase recommendation the senior manager was selling his own shares in the company and was also selling the shares of his customers. The court held that on the facts Shearson Hamill had breached its duty to its customers who, on the recommendation of the firm's salesmen, had bought the shares. The facts in *Black* v. *Shearson, Hammill & Co.* were somewhat exceptional in that the non-communication of the information was not pursuant to any policy that underlies the creation of a Chinese wall but rather to further the senior manager's own personal interests.[96] Some have argued that in a conflict of interest situation a Chinese wall will not by itself suffice to protect a firm and that more is required. This is dealt with in paragraph 4.5.24 dealing with stop lists and watch lists. However, unless (i) the firm is protected by Core Rule 36 or (ii) the customer consents to the conflict, it is difficult to see how the mere existence of a Chinese wall can protect a firm where it enters into a transaction in which it has a material interest which conflicts with that of its customer.

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[94] See *North and South Trust Co.* v. *Berkeley* [1971] 1 W.L.R. 470, 484-485; see quotation in para. 3.4.21, above.

[95] 72 Cal. Rptr. 157 (1968). For other American authorities see Lipton and Mazur, "The Chinese Wall Solution to the Conflict Problems of Securities Firms", (1975) 50 N.Y.U.L.R. 459. See also *Washington Steel Corporation v. T W Corporation* 602 F 2d 594 (1979). For Canadian authority see *Standard Investments Ltd.* v. *Canadian Imperial Bank of Commerce* (1986) 22 D.L.R. (4d) 410 (bank in breach of duty in acting for two customers who were both interested in taking over the same company. No Chinese wall appears to have been established by the bank in that case).; Crawford, "Bankers' Fiduciary Duty and Negligence", (1986) 12 C.B.L.J. 145, at 161: "Chinese Wall would have to be supported by legislation that relieved fiduciaries from their duties".

4.5.19 One other aspect of Core Rule 36 needs to be emphasised. Core Rule 36(3) provides that for the purpose of the Core Rules a firm will not be acting with knowledge if none of the relevant individuals acting for the firm has knowledge. This state of ignorance would be achieved if the firm has an established arrangement satisfying the requirements of Core Rule 36(1). This raises no problems of mismatch since Rule 36(3) is restricted to the operation of the rules themselves and does not affect any common law duties.[97]

Crossing the Wall

4.5.20 Many of the respondents to the Issues Questionnaire referred to the practice of bringing a person over the wall with respect to a particular transaction. This is not dealt with in Core Rule 36 which is designed to legitimate arrangements which restrict the flow of information and which does not apply where an individual acts with knowledge, i.e. where information has passed across a Chinese wall. The most common example was bringing an industry or sectoral analyst over the wall to advise the corporate finance department with respect to a particular transaction. We will refer to the person who is brought over the wall as the "analyst". It was clear from the responses to the Issues Questionnaire and from our discussions with respondents that where best practice is observed the decision to bring an analyst over the wall is not made lightly. This is partly because of the regulatory problems to which it gives rise, and partly because of commercial self-interest, in that the analyst would not be able to operate in the normal way during the period when he was over the wall.[98] There are obviously various ways of handling this issue but good practice with respect to someone crossing the wall appears broadly to take the following form:

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[96] This point is developed in Lipton and Mazur, "The Chinese Wall Solution to the Conflict Problems of Securities Firms", (1975) 50 N.Y.U.L.R. 459 at 477-478.

[97] Core Rule 36(2) deals with communication within a group of firms and is made to operate only with respect to the Core Rules. For the definition of "group", see The Financial Services Glossary 1991 (2nd ed.) set out in Appendix 3.

(i) The decision to bring an analyst over the wall should only be made after careful deliberation and at an appropriate level of managerial seniority.

(ii) If the analyst's superior has the right to refuse a request for the analyst's services, care must be taken at the stage of the initial request to ensure that information of a confidential nature is not unwittingly revealed by the department making the request. For this reason, it would, where possible, be appropriate to channel the initial request through the compliance officer.

(iii) The analyst should only be provided with the minimum amount of information that he needs to know in order to enable him to carry out his task. This would also require that the information provided makes him knowledgeable for as short a period as possible. To achieve this position of minimal knowledge attention has to be paid to at least the following: (i) the timing of the analyst's move across the wall and (ii) the type of information that is disclosed. The reason for (i) is reasonably self-evident as it prevents the analyst from being privy to confidential information until the last possible moment. The reason for (ii) is slightly more complex. This is designed to ensure that, as far as possible, the analyst is provided only with information that has a relatively short "shelf life". Thus, for example, the disclosure of forecasts could result in the analyst being in possession of confidential information for a considerable period of time and this is something that should, where possible, be avoided.

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[98] A small firm may only have a single analyst dealing with a particular matter with the inevitable consequence that when the analyst crosses the wall the firm will not be able to provide a service.

(iv) The compliance department should monitor the process, and this, among other things, could necessitate the monitoring of the analyst's conduct after he has returned over the wall.

When we refer to persons crossing the wall we will be referring to situations where an attempt has been made to follow good practice along the lines set out above.

4.5.21 There are a number of problems associated with an analyst crossing the wall. First, there is the question of what happens to the analyst's customers when he is over the wall. As a practical matter, there will be many situations when an analyst is out of circulation and not able to advise customers in the normal way. This could prejudice the customer, but it is up to the firm to ensure that this does not happen. More importantly, it may be that the unavailability of the analyst will send a signal to the customer that something is afoot and the customer may put two and two together and come up with four. This point is dealt with in the next paragraph.

4.5.22 By far the most difficult problem is what happens to the analyst when he returns over the wall. It is clear from our consultations that this presents a very difficult problem, the solution of which is far from easy. In fact the difficulty of this is such that it suggests that in a perfect world analysts should not be permitted to cross the wall. However, given that they do, one way of regulating the problem on their return would be to take the analyst out of circulation until the confidential information is stale or is part of the public domain. From the responses to our Issues Questionnaire this is very much the exception. This solution is not free from difficulty. It would be particularly burdensome on small firms who only have a single analyst in a given field. This would undoubtedly have competition implications. Also, if the analyst is taken out of circulation this could, as was pointed out above, unwittingly tip off his customers that something was afoot. It may be that this aspect of the problem is somewhat exaggerated and we had difficulty in assessing its likelihood and extent from the responses to the Issues Questionnaire. Our preliminary view is that taking an analyst out of circulation until confidential information that he possesses is no longer price sensitive does not give rise to such a serious risk of indirectly communicating to a shrewd customer the nature of the information that it could not for this reason be adopted. After all, the problem of what happens when the analyst is out of circulation because he is across the wall appears to be dealt with adequately at present. Also, to the extent that there is a problem, it is difficult to see how a firm could be seen to have breached any duty where a customer does draw the right inference from his inability to deal with a particular analyst. Whatever a firm can be treated as doing when it prohibits an analyst from resuming his normal duties, it scarcely constitutes the improper *communication* of confidential information. Accordingly, it is arguable that the problem of the analyst crossing the wall can be adequately dealt with by the firm putting the analyst into quarantine until it is safe for him to return to his normal task. By bringing the analyst across the wall the firm has created conditions giving rise to the potential conflict and it is up to it to sort out the ensuing problems. If quarantine of the analyst is seen as the answer, then this can be left to the firm to implement. We invite views as to how necessary wall crossing by analysts is thought to be. We would also appreciate views on the feasibility of placing an analyst who crosses the wall in quarantine until the confidential information that he possesses becomes stale or part of the public forum, and also on how the issue of inadvertent signalling to customers is presently dealt with when an analyst crosses the wall.

Management Oversight : "Overlooking" the Wall

4.5.23 In some situations a person because of his managerial position will overlook the wall in the sense that his "need to know" in order for him to discharge his duties will result in him obtaining information which is otherwise retained behind a Chinese wall.[99] Obviously good practice can be followed in this situation by reducing to the minimum the occasions on which this occurs and the range and nature of the information divulged. Where this gives rise to a conflict which is one of duty, the firm can obtain whatever protection is provided by disclosure and consent. Where it is one of interests, the situation is more problematical. For example, where the head of the private client department knows that his dealers are positively recommending the purchase of shares of a company which he has discovered, because of his membership of the main board, is on the verge of insolvency, the conflict between the firm's interest in commission income and its duty to protect the interests of the customer is very acute.[100] Protection by agreement to each individual conflict would not be practicable and therefore reliance would have to be placed on generalised consents or on some regulatory rule providing a safe harbour. It may be that the procedure set out in the next paragraph will provide a solution to the problem of conflict of interests where a senior manager or compliance officer exercises oversight of the wall in this way.

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[99] "It remains the fact, however, that both in the smaller Houses and in the larger ones individuals at the higher level of management and certainly at Board level must possess some degree of information and of responsibility in both departments" (i.e. the corporate advice and investment advice departments): "The Use of Confidential Price-Sensitive Information", The Panel on Take-Overs and Mergers, Report on the Year Ended 31st March 1979, Appendix I at 11.

Stop Lists and Watch Lists

4.5.24 Although not a universal practice, many of the respondents to our Questionnaire make use of "stop" or "watch" (sometimes referred to as "grey" or "monitored") lists. These are not terms of art. They refer to practices whereby trading in a designated share is either prohibited (a stop list) or trading in a share is monitored (a watch list), the latter practice often being part of a firm's compliance programme with respect to employee trading. Where straddling the wall does give rise to acute conflict of interest difficulties, the use of stop lists could provide a solution.[101] The firm would simply decline to deal in the relevant security until the conflict had ceased to exist. A slightly less drastic policy would be for the firm to have a policy of refusing to recommend a share where this would create a conflict between the firm's interests and those of its customers but nevertheless executing unsolicited orders with respect to the share.[102] Where a firm does place a share on a stop list there is the danger that this could signal that the firm has information relevant to the security although it would not indicate if the information is favourable or unfavourable. A possible solution to this would be (i) either to have, as some respondents to our Questionnaire did, a list that as a matter of policy contains other shares on which the firm has no information to camouflage the position, or, alternatively, (ii) once a company becomes a customer of the firm its shares would be placed automatically on a stop list.[103] Where a firm does adopt a "restricted list" policy, presumably its discretionary customers would have to agree to it otherwise it would breach its duty to give best advice to such customers. We would appreciate views on the feasibility of these solutions. We would also appreciate views on how the inadvertent signalling effect is presently avoided where a firm places securities on a stop list.

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[100] In this situation the Panel has considered that the person with knowledge should be completely excused from having to give advice: see "The Use of Confidential Price-Sensitive Information", The Panel on Take-Overs and Mergers, Report on the Year Ended 31st March 1979, Appendix I at 13. This may alleviate the dilemma of the person with the information but it is not of much solace to the customer and does not resolve the firm's conflict problem. The conflict would be even more acute where the firm's market maker was long in the share and the dealer's order was satisfied from the market maker's book. It is important to note that the reason why the Chinese wall does not operate in this situation is because the firm, through its "tainted" officer, knows of the relevant information because the firm's organisational structure prevents the wall from operating to preclude attribution of knowledge to him.

[101] The Council for the Securities Industry was of the opinion that as regards small firms stop lists might be needed in order to reinforce the Chinese wall: see Annual Report, March 1985 at 21.

The Protection Provided By Chinese Walls

4.5.25 The extent to which Chinese walls by themselves[104] provide protection to a firm against liability for breach of duty owed to a customer is not something to which a dogmatic answer can be given. This is a matter of concern since they are a central device for managing conflict in a firm. It is clear that as far as the Core Rules are concerned there is little doubt that effect can be given to a Chinese wall for the purpose of the operation of the Rules.[105] Also, where a Chinese wall is designed to prevent a breach of the criminal law, there is a plausible argument that it does provide protection in that a firm cannot be expected to commit an illegality on behalf of any customer and therefore steps that are designed to prevent this from occurring are to that extent legitimated.[106] After this the picture becomes unclear, and we shall see that, as a matter of public law,[107] where the wall has remained intact the attribution of knowledge rule within a corporate entity or partnership may have been affected by Core Rule 36. However, it is clear that, as a matter of private law, the Chinese wall does not afford the type of protection that is needed for a firm to carry on its functions with the degree of assurance that the wall is designed to provide. Three typical examples illustrate this:

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[102] This, however, would not solve the duty of loyalty problem if the firm had a duty to advise. See Lipton and Mazur, "The Chinese Wall Solution to the Conflict Problems of Security Firms", (1975) 50 N.Y.U.L.R. 459, who recommend that the firm should have a stop list and no recommendation policy where the firm is investing in a particular share on its own account and it has inside information, even though, of course, its own trading would not be on the basis of this information.

[103] See *Slade v. Shearson, Hammill & Co. Inc.* 517 F. 2d 398 (1974).

[104] I.e., disregarding client consent and the public law status of the regulatory rules. See paras. 3.4.29-3.4.31 and para. 4.5.16, above and paras. 5.3.16-5.3.21 and para. 5.5.1, below.

[105] See, for example, Core Rule 36(2) and (3).

(i) A customer is entitled to a duty of loyalty from a firm which requires it to put at its customer's disposal all information in its possession which is relevant to the discharge of the obligations that it has assumed.[108] This information may have been acquired from another confidential relationship which the firm must also respect. It is no answer to this dilemma to say that the information is confidential since the firm should not have put itself in a position where the duty that it owes to one customer cannot be properly discharged because of a duty owed to another customer. Also, even if the Chinese wall is treated as providing protection in this situation, it does not provide any protection where a person overlooks the wall for the purpose of discharging his duties to the firm.[109]

(ii) A person responsible for oversight of two separate departments knows that one department is recommending to customers a course of conduct which information in the possession of another department indicates to be clearly ill advised. This is somewhat similar to (i), but here the firm is actively advocating a course of conduct which it "knows" to be against the interests of its customer.

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[106] But cf. argument in para. 4.5.17.

[107] See Part V, below.

[108] See *Spector v. Ageda* [1973] Ch. 30; Finn, "Fiduciary Law and the Modern Commercial World", Norton Rose Oxford Law Colloquium (September 1991).

[109] Even if Chinese walls are effective as a matter of public law they will not, as Core Rule 36 is currently drafted, provide protection where information crosses the wall.

(iii) Where there is a conflict between the interests of a firm and its customer where the firm is acting in a fiduciary capacity, it is difficult to see how the Chinese wall can provide any protection. A straightforward example of this is where the firm sells to the customer assets of which it is the beneficial owner or in which it has an interest.

4.6 European Community Legislation

4.6.1 Also relevant to the management of conflict is European Community legislation. The most important provision is the Insider Dealing Directive[110] which was adopted in 1989 and which Member States have to implement by 1 June 1992. This requires Member States to prohibit certain persons[111] from trading in transferable securities[112] in a recognised or regulated public market on the basis of inside information.[113] The Directive does not give rise to any significant problems with respect to the managing of conflict. In so far as the terms of any agreement between a firm and its customer, or any structural arrangements are designed to ensure compliance with the Directive or any legislation that implements it, this would provide added support for the effectiveness of these techniques in providing protection to the firm. There is nothing in the Directive itself which cuts down their effectiveness.

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[110] 89/592/EEC (O.J. 1989, L334/330).

[111] Art. 2 defines who has to be covered by the prohibition. Broadly it is directors, shareholders, employees and other professional persons who by virtue of their position have access to inside information.

[112] Art. 2 defines transferable security.

[113] Art. 1 defines inside information as non-public information which if made public would be likely to have a significant effect on the price of the shares in question.

4.6.2 The only other EC initiative of any significance[114] is the proposed Directive on investment services which is designed to enable a firm or an individual authorised to carry on investment services in one Member State to carry on business in other Member States.[115] The draft Directive provides that the Member States shall not authorise a person to carry on business unless, inter alia, "the persons who effectively direct the business of the investment firm are of sufficiently good repute and experience."[116] To this end Member States are obliged to draw up prudential rules to be observed by firms authorised by them to carry on investment business. Among the rules that Member States have an obligation to draw up are rules which shall require that an authorised firm is "organized in such a way that conflicts of interest between the firm and its clients or between one of its clients and another do not result in clients' interests being prejudiced".[117] If implemented, this would result in any Chinese wall arrangement that was recognised by the implementing legislation to be squarely part of public law and which could override the common law. It is important to note, however, that the Directive only requires rules that are designed to protect the interests of customers in situations of conflict and does not require rules that reduce the level of protection. In principle a Directive could operate to qualify the protection offered by fiduciary rules.

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114. Also of slight relevance is the Admissions Directive (EC/79/279, O.J. 1979, L66/21) which requires all companies which have an official listing on the Stock Exchange to ensure "equal treatment for all shareholders who are in the same position" (Sch. C, para. 2(a) which is implemented by Yellow Book, s. 5, ch. 2, para. 4(a)). This would only apply in very limited circumstances where the firm is listed and it is providing one of its customers who is also a shareholder with information that it is not providing to other shareholders.

115. 90/C, 42/06.

116. Art. 3(2) (second indent).

117. Art. 11(1). A new Article 11a has been added obliging member States to draw up rules of conduct to ensure that investment firms act honestly and fairly in the best interests of their customers.

PART V

THE PUBLIC LAW DIMENSION

5.1 Introduction

5.1.1 We have now considered the regulatory framework and the contractual and structural techniques for dealing with mismatch or conflict between fiduciary duties and regulatory rules. In this part we consider whether the rules of the regulatory bodies under consideration are instruments of public law and, insofar as they are, the consequences of this. To the extent that the rules are instruments of public law we consider their impact on the mutual rights and obligations of those subject to regulation on the one hand and either the regulatory body or third parties (the customers) who deal with a person subject to regulation on the other.

5.1.2 The determination of the effect of rules made by regulatory bodies operating in the public law sphere on common law and equitable rights and duties depends on two factors. Firstly, whether the regulators have been given authority, whether by statute or otherwise, to alter private law rights, and secondly, if there is authority, whether the regulators have in fact exercised it. Where the statute does not state the position clearly and a rule is made which appears to conflict with or modify common law or equitable duties the outcome will, as will be seen, depend on the strength in the particular context of the presumption that statutes do not alter the common law, a presumption which has been said to be weaker in the case of modern statutes laying down a coherent regulatory scheme.[1] We shall use three models as aids to the consideration of the different possible approaches that might be taken to the question: a "public law model" where the presumption is weakest, a "private law model" where it is strongest and a "hybrid model".

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[1] See para. 5.4.4, below.

5.1.3 We are particularly concerned with the impact on the common law and equitable rights and duties of those subject to regulation and their customers. It should be recalled that there are several ways in which regulatory rules and practices raise questions as to their relationship with common law and equitable duties.

(i) There may be market practices which the rules assume to be, but do not explicitly make, legitimate. The position of the general consent in advance provisions in broker/dealers' customer agreements about the capacity in which the broker/dealer may be acting[2] and the disclosure of commission[3] fall into this category.

(ii) There may be detailed rules about a particular matter.[4]

(iii) There is a contrast between "real" conflicts of regulatory and general law and situations in which the regulatory rule sets a less onerous standard than the general law but does not prohibit compliance with the higher standard.[5]

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[2] By FSA Sch. 8, para. 6 the rules of the SIB must make proper provision for requiring the capacity in which an authorised person enters a transaction to be disclosed. See SIB Principle 6 ("Conflicts of Interest"); Core Rule 2 ("Material Interest"); Core Rule 18(2) (disclosure of basis or amount of charges or other remuneration). By the SFA Conduct of Business Rules disclosure is not required of "any commission received from another customer as a result of a simultaneous matching transaction" (Rule 5-33(3)). This disclosure will normally be on the contract note; i.e. post transaction, SFA Table 5-34(2), para. 11. Cf. SFA Rule 5-23(3). See paras. 3.4.23 and 3.4.34, above.

[3] See Core Rule 18, set out in Appendix 3.

[4] The Financial Services (Client Money) Regulations 1991; The Financial Services (Client Money) (Supplementary) Regulations 1991 and possibly Core Rule 36 on "Chinese Walls", which has been considered in paras. 4.5.12-4.5.13, above.

[5] See further para. 1.13, above.

5.2 Public Law and Private Law

5.2.1 English law has traditionally avoided precise delineation of the respective spheres of "public law" and "private law". However, recently a distinction between the two bodies of law has been developed by the courts in a number of contexts and for a variety of purposes.[6] The bulk of the case law has concerned the applicability of the supervisory jurisdiction by way of judicial review under R.S.C. Order 53. The issues include the amenability of a body to judicial review and, if it is amenable, whether the "exclusivity" rule laid down in *O'Reilly* v. *Mackman*,[7] that public law rights must as a general rule be vindicated by the judicial review procedure, applies.[8] The distinction between public law and private law has also been drawn for other purposes, including, for instance, the determination of the scope of the tort liability of bodies exercising statutory powers,[9] the extent to which such bodies can fetter their discretion by binding contracts or statements, the scope of restitutionary remedies,[10] and the meaning of "the state" for the purposes of the European Community law doctrine of direct effect.[11]

5.2.2 A number of tests have been used to elucidate the meaning of public law. These include the source of the authority's power, the scope of the prerogative remedies of certiorari, mandamus and prohibition, and the nature of the authority's power, in particular, whether the power in question is "governmental".

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[6] Wade, *Administrative Law* (6th ed., 1988), at 35, 676-687. See also Harlow, "'Public' and 'Private' Law: Definition without Distinction", (1980) 43 M.L.R. 241; Beatson, "'Public' and 'Private' in English Administrative Law", (1987) 103 L.Q.R. 34; Cane, "Public Law and Private Law: A Study of the Analysis and Use of a Legal Concept", in *Oxford Essays in Jurisprudence* (3rd series, 1987) (eds. Eekelaar & Bell), ch. 3.

[7] [1983] 2 A.C. 237.

[8] Craig, *Administrative Law* (2nd ed., 1989), at 411-421; Wade, *op. cit.*, at 678-687.

[9] *Anns* v. *Merton L.B.C.* [1978] A.C. 728. The immunity of authorities for ultra vires action at the "policy" level appears to have survived *Murphy* v. *Brentwood D.C.* [1991] 1 A.C. 398. On the position of regulatory authorities, see *Yuen Kun Yeu* v. *A.G. of Hong Kong* [1988] A.C. 175; McLean, "Negligent Regulatory Authorities and the Duty of Care", (1988) 8 O.J.L.S. 442.

[10] *Auckland Harbour Board* v. *R.* [1924] A.C. 318; *Woolwich Equitable Building Society* v. *I.R.C.* [1991] 3 W.L.R. 790 (C.A.) ("special" rules for public law restitutionary claims).

[11] See paras. 5.2.8-5.2.9, below.

5.2.3 Apart from central and local government officials and departments exercising statutory or prerogative powers, a wide variety of statutory and non-statutory bodies have been held to operate in the public law sphere and to be subject to judicial review under R.S.C. Order. 53.[12] In the case of non-statutory bodies the judicial review jurisdiction may be based on one of a number of approaches. For instance, the jurisdiction over the Bar Council rests on the powers of the judges derived from the Crown to provide and regulate lawyers to conduct the business of the royal courts, which powers were delegated first to the Inns of Court and then to the Bar Council.[13] In the case of the Take-over Panel and the Advertising Standards Authority what was important was the fact that, in the absence of the self-regulatory body, regulation would have been exercised by government, a notion of "delegation" by government. In the case of the Take-over Panel Sir John Donaldson M.R. stated that:

> "[a]s an act of government it was decided that, in relation to take-overs, there should be a central self-regulatory body which would be supported and sustained by a periphery of statutory powers and penalties wherever non-statutory powers and penalties were insufficient or non-existent or where EEC requirements called for statutory provisions".[14]

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[12] *R.* v. *Director General of Fair Trading, ex p. F.H. Taylor & Co. Ltd* [1981] I.C.R. 292; *R.* v. *Civil Aviation Authority, ex p. British Airways* 21 September 1983; *R.* v. *Panel on Take-overs and Mergers, ex p. Datafin plc* [1987] Q.B. 815; *R.* v. *Law Society Criminal Legal Aid Committee, ex p. Magerou* [1989] C.O.D. 535; *R.* v. *Advertising Standards Authority Ltd., ex p. The Insurance Service plc* (1990) 2 Admin. L.R. 77.

[13] See *R.* v. *General Council of the Bar, ex p. Percival* [1991] 1 Q.B. 212, and para. 5.3.36, below.

[14] *R.* v. *Panel on Take-overs and Mergers, ex p. Datafin Plc* [1987] Q.B. 815, 835. The statutory support included at various times the Prevention of Fraud (Investments) Act Licensing Regulations 1944 S.R. & O. 1944/19; the Prevention of Fraud (Investments) Act 1958; Banking Act 1979; Licensed Dealers (Conduct of Business) Rules S.I. 1983/585; The Stock Exchange (Listing) Regulations 1984 S.I. 1984/716; the last implemented EC Directive 79/279 of 5th March 1979.

In the Advertising Standards Authority case the fact that, in the absence of the Authority, control would have to be exercised by the Director General of Fair Trading,[15] whose powers were in fact only exercised where the Authority's remedy was inadequate, was taken into account.

5.2.4 To sum up, in determining whether a non-statutory or self-regulatory body is amenable to the supervisory jurisdiction by way of judicial review, the test has been said to be whether it exercises de facto non-consensual power which power is either supported and sustained by a periphery of statutory powers and penalties, or by a government decision that there should be self-regulation or by a combination of the two. The notion of delegation by government which has influenced the scope of the judicial review procedure can also be seen in the delineation of public law.[16]

5.2.5 The tests outlined above have, however, not proved entirely satisfactory. The "source of power" test could bring in the activities of private companies or bodies whose activities are to some extent regulated by statute.[17] Furthermore, not all the activities of public bodies raise "public law" issues.[18] The "scope of the prerogative remedies" test involves a degree of circularity[19] and risks determining the issue by the mode of regulation used[20] which may be a historical accident. The "nature of the power" test also appears circular and to beg the question[21] unless, as has been suggested,[22] whether a power is "governmental" is a practical rather than an a priori question. On this approach what has to be asked is whether government has in fact decided that a particular form of regulation be used, or would in fact undertake the regulatory function itself if the self-regulatory body had not.

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[15] EC Directive 84/450 EEC dated 10 September 1984 (O.J. 1984, L250/17) required that member states shall ensure that adequate and effective means exist for the control of misleading advertising. The Control of Misleading Advertisements Regulations 1988 S.I. 1988/915 implemented this.

[16] *Foster* v. *British Gas Plc* [1991] 1 Q.B. 405; 2 A.C. 306; *D.* v. *N.S.P.C.C.* [1978] A.C. 171.

[17] E.g. *Allen* v. *Gulf Oil Refining Ltd.* [1981] A.C. 1001.

[18] See *R.* v. *East Berkshire H.A., ex p. Walsh* [1985] Q.B. 152 (the exercise of purely contractual powers); *R.* v. *National Coal Board, ex p. N.U.M.* [1986] I.C.R. 791 ("managerial" powers); *Bird* v. *Pearce* [1978] R.T.R. 290 aff'd [1979] R.T.R. 369 (highway authority's liability for negligence at the "operational" level); *Page Motors Ltd.* v. *Epsom & Ewell B.C.* (1981) 80 L.G.R. 337 (whether occupation of council's land by gypsies constituted a nuisance).

[19] *R.* v. *East Berkshire H.A., ex p. Walsh* [1985] Q.B. 152, 162 per Sir John Donaldson M.R.

[20] I.e. whether it is by statute, charter or contract.

5.2.6 Such difficulties led the *JUSTICE - All Souls Review of Administrative Law in the United Kingdom* to conclude that the term "public law" was imprecise and that no clear-cut distinction between public law and private law rights could consistently be drawn. It said that:

> "[t]he term 'public law' has been useful to remind courts and practitioners that in many administrative law cases there are values and interests to be upheld which transcend the private rights normally the subject of litigation between individuals, but it is, in our view, dangerous to suppose that there is a category of right which can be clearly identified as a public law right".[23]

This observation was made in the context of the scope of Order 53 and the *O'Reilly* v. *Mackman* "exclusivity" rule[24] which was considered an unfortunate development.[25]

5.2.7 However, our concern is not with Order 53 but with the impact of regulatory rules on the substantive rights and duties of a regulated profession or industry and its customers and on the relationship between the members of the profession or industry and the regulators. The tests to determine the scope of the application for judicial review may or may not be sufficiently precise, but in any event they are not determinative of the questions we are considering. At most they can only be indications of the situations in which, as the *JUSTICE - All Souls Review* put it, considerations of a broader nature can affect and possibly transcend private rights: situations which may be demarcated by the term "public law". The wider considerations might include the public interest in having a particular commercial and institutional structure in a given area of activity, in having effective mechanisms for the protection of customers which do not depend upon individual recourse to the courts, and in having a clearly understood and certain body of law. The determination of whether an area is subject to public law regulation and, if so, whether such regulation may affect private rights, depends on a fuller examination of the particular regulatory areas under consideration. The regulatory structures and the rulemaking powers given have been described in Part II. We shall now consider if they operate in the public law sphere and whether, and if so to what extent, their rules can and do affect the private law rights and duties of those subject to them. Before doing so, we shall turn briefly to European Community legislation.

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[21] Craig, *Administrative Law* (2nd ed., 1989), at 420.

[22] Cane, "Self Regulation and Judicial Review", [1987] 6 C.J.Q. 324, 337.

[23] Report of the Committee of the JUSTICE - All Souls Review of Administrative Law in the United Kingdom, *Administrative Justice: Some Necessary Reforms* (1988), at 150.

[24] [1983] 2 A.C. 237, see para. 5.2.1, above.

[25] *Administrative Justice: Some Necessary Reforms* (1988), at 149.

European Community Legislation

5.2.8 As we have already seen,[26] the European Community has enacted legislation relating to the financial markets and there is every likelihood that this trend will continue.[27] This legislation normally takes the form of a Directive which by Article 189 of the Treaty is binding on the Member States as to the result to be achieved. The House of Lords has held that in interpreting any legislation which is designed to implement a Directive the court should give it a purposive construction and take into consideration the terms of the Directive and any decisions of the European Court of Justice implementing it.[28] Until recently, the orthodox view was that Directives only have vertical direct effect, that is, they only affect the relationship between a citizen and the state[29] and they do not have horizontal direct effect in the sense that they cannot be invoked by one citizen against another so as to impose an obligation on the latter.[30] This position has been substantially qualified by the recent decision in *Marleasing SA* v. *La Commercial Internacional de Alimentacion SA*[31] where the European Court of Justice held that the Spanish courts would have to interpret the Spanish law relating to the nullity of companies in the light of Article 11 of the First Company Law Directive[32] which limits the grounds on which Member States may provide for the nullity of companies. The basis for this obligation was Article 5 of the Treaty which obliges Member States to take all appropriate measures to ensure the fulfilment of their obligations as members of the Community. This obligation was imposed on all "authorities" of Member States, which includes the courts, and it applies whether or not the Member State has taken steps to implement the Directive.[33] Thus *Marleasing* has the potential of attributing to Directives an effect which as a matter of substance is horizontal.[34]

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[26] See paras. 4.6.1-4.6.2, above.

[27] Community law prevails over statute law and common law: European Communities Act 1972, s. 2; *R.* v. *Secretary of State for Transport, ex p. Factortame Ltd. (No. 2)* [1991] 1 A.C. 603; *W.H. Smith Do-It-All Ltd.* v. *Peterborough City Council* [1991] 1 Q.B. 304.

[28] *Litster* v. *Forth Dry Dock & Engineering Co Ltd* [1990] 1 A.C. 546. There is authority that the Directive cannot be taken into consideration when interpreting legislation which antedates the Directive but which achieves the purpose in the Directive: see *Organon Laboratories Ltd.* v. *D.H.S.S.* [1990] 2 C.M.L.R. 49. As a rule of construction this makes sense but as a principle of constitutional law it is open to question: see Wyatt, "Enforcing EEC Social Rights in the United Kingdom", (1989) 18 Ind. L. Jr. 197 at 211 ("It seems anomalous that if a Member State chooses to rely on pre-existing

5.2.9 Whatever the impact of *Marleasing*, it is clear that a Directive can affect the legal relations between a citizen and emanations of the state ("public bodies"). Accordingly, the

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legislation it is thereby excused the duty to take Community law into account when construing it, in the event of a potential conflict.") Also, it is not compatible with the *Marleasing* case (to be discussed later): see para. 8 of the judgment in that case.

[29] Other conditions have to be satisfied. The Directive must be clear and unambiguous, be unconditional and not be dependent for its operation on any further action being taken by national or Community authorities: see Dashwood, "The Principle of Direct Effect in European Community Law", (1977) 16 J.C.M.S 229.

[30] See Hartley, *The Foundations of European Community Law* (2nd ed., 1988), at 208-11; Prechal, "Remedies After Marshall", (1990) 27 C.M.L.Rev. 451.

[31] Case C-106/89 (judgment of the E.C.J. of 13 Nov. 1990)

[32] 68/151/EEC (O.J. 1968, L65/8).

[33] In *Marleasing* the Spanish authorities had not implemented the Directive.

[34] In *Von Colson and Kamann* v. *Land Nordrhein-Westfalen* Case 14/83 [1984] 2 E.C.R. 1891, where the member states had purportedly implemented the directive the Court placed importance on a similar line of reasoning. See Steiner, "Coming to Terms with EEC Directives", (1990) 106 L.Q.R. 144.

question arises as to what constitutes a public body for the purpose of European legislation. It is not confined to government departments but extends to

> "a body, whatever its legal form, which has been made responsible, pursuant to a measure adopted by the state, for providing a public service under the control of the state and has for that purpose special powers beyond those which result from the normal rules applicable in relations between individuals".[35]

Thus, for example, any body vested with the responsibility of implementing or enforcing the terms of a Directive would clearly be a public body for the purposes of European legislation.[36] The rules of such a body would undoubtedly be part of public law in so far as they were designed to implement the Directive but only so far as they were designed to achieve this purpose. If the body went beyond the terms of the Directive, then its rules (provided they did not infringe any principle of Community law) would not be associated with the obligation to implement community legislation and their status would have to be determined solely by domestic law.

5.3 The Regulated Professions and Business

(i) **Financial Services**

The Securities and Investments Board.

5.3.1 The SIB is clearly a body operating in the public law sphere[37]. The combined effect of the 1986 Act and the delegation by the Secretary of State gives the SIB extensive executive, enforcement and rulemaking powers. Its decisions on authorisation, disqualification, making public statements of misconduct and the exercise of its powers of intervention are subject to appeal to a statutory tribunal, the Financial Services Tribunal.[38] The exercise by the SIB of its executive enforcement and rulemaking powers are clearly amenable to judicial review on the tests set out above.

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[35] *Foster* v. *British Gas Plc* [1991] 1 Q.B. 405, 428 (E.C.J.) holding that the British Gas Corporation (the predecessor to British Gas Plc) was a public body for the purposes of Community law. See also [1991] 2 A.C. 306 (H.L.).

[36] Under FSA, s. 142(6) the Council of The Stock Exchange is made the competent authority for the official listing of securities which is regulated by the Listing Directives.

[37] SIB accepts that it is: see *A Forward Look* (October 1989), Annex 1, para. 2. On the tests summarised in Section 5.2, above, it is clearly amenable to judicial review. In *SIB* v. *FIMBRA* [1991] 3 W.L.R. 889 Morritt J. thought this was so but permitted the SIB, which did not seek the

5.3.2 In paragraph 2.5.10 we divided the SIB's rulemaking powers into five broad categories. The third of these, rulemaking powers about matters affecting relations between authorised persons and those doing or who may do business with them, is our concern here. This category of rulemaking power can itself be divided into powers which expressly or by implication address the private law relationship between authorised persons and their customers, and powers which do not. Those which do, or which arguably do, address this relationship are the powers under sections 81, 55 and 48 of the FSA. We shall set out the relevant parts of these provisions here but our conclusions on the impact of rules made under these provisions on private law rights arising under the general law will be found in the "Analysis" section of this chapter.[39] Ultimately, the question is one of interpretation: what is the extent of the particular rulemaking power? Where there is statutory authority to modify common law and equitable rights and duties, a rule which does so will be valid unless it is set aside in judicial review proceedings. Where the statute does not expressly address the issue, the answer in relation to a particular rulemaking power will turn on the court's perception of the nature of these public law rules: i.e. which of the models discussed in the "Analysis" section prevails. It will be seen that even where a regulatory body has no authority

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protection of Order 53, to proceed by originating summons because there was no objection and because of Order 5 r. 4(2). Cf., however, the different views expressed in Parliament on the general issue; 89 H.C. Deb. 941, 96 H.C. Deb. 418W, 99 H.C. Deb. 602-4. See also *European American Corp.* v. *SIB* (11 July 1991) in which the U.S. District Court (D.C. Circuit) held that the SIB is entitled to sovereign immunity under United States Law.

[38] FSA, s. 97. A matter may be referred to the tribunal by the person against whom the decision is made or any person on whom a copy of the statutory notice of the decision is served. The tribunal is subject to the control of the Council on Tribunals and appeals lie from it to the High Court on a point of law; FSA Sch. 6, para. 6. See also, para. 2.5.5, above.

[39] See paras. 5.4.1-5.4.29, below.

dispositively to modify common law and equitable duties, courts can give some recognition to the public law nature of the regulatory rules by taking account of reasonable rules in ascertaining the precise content in a given context of a common law or equitable obligation.

5.3.3 Before, however, turning to the statute, it should be noted that the two pre-legislative reports, Professor Gower's *Review of Investor Protection*[40] and the Government's White Paper,[41] do not provide clear guidance.[42] Professor Gower's report called for the regulatory rules to embody basic principles of law[43] but this could either require that the equitable rules be reproduced exactly or permit such variation as did not subvert the fundamental purposes served by those rules. The White Paper contains a number of statements about the relationship between the two including the following:

(i) "where an investment business acts as agent for a client, the general rules of agency and consequent fiduciary duties apply to the business."[44]

(ii) Specific conflicts of interest would need to be resolved in accordance with a "best execution" principle and a "subordination of interest" requirement.[45] Apparently, although this is not expressly stated, this was to be done in regulatory rules. The Government was not convinced that total reliance could be placed on Chinese walls because they restricted flows of information and not the conflicts of interest themselves.[46]

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[40] (1984), Cmnd 9125.

[41] *Financial Services in the United Kingdom: A New Framework For Investor Protection* (1985), Cmnd. 9432.

[42] In retrospect this was unfortunate. Compare the confusion as to whether a breach of statutory duty gives rise to civil liability; Buckley, "Liability in Tort for Breach of Statutory Duty", (1984) 100 L.Q.R. 204; *The Interpretation of Statutes* (1969), Law Com. No. 21, Scot. Law. Com. No. 11, para. 38.

[43] Para. 6.30.

[44] Para. 7.6.

[45] *Ibid.*, On this see FSA, Sch. 8, para. 3.

(iii) The law should provide a clearly understood set of general principles and rules to facilitate the objectives of the new framework for investor protection.[47]

The first statement indicates an intention to preserve the general law which would have regulatory rules providing an *additional* layer of investor protection and many commentators take the view that this is what the FSA provides.[48] However, the second statement envisages new methods of resolving conflicts and the third statement, which envisages a single set of general principles, does not address the question of the relationship between regulatory rules and fiduciary duties. It is clear that the aim of the regulatory system is to provide a framework for investor protection. Undoubtedly, fiduciary duties also seek to provide for investor protection. So any separation of regulatory rules and "ordinary" law could be an impediment to the achievement of a clearly understood body of law.

5.3.4 Turning to the FSA's powers, by section 81(1) regulations may be made[49] "as to the constitution and management of authorised unit trust schemes, the powers and duties of the manager and trustee of any such scheme and *the rights and obligations* of the participants in any such scheme" (emphasis supplied). The emphasised words have been generally accepted as authorising modification of the underlying common law or equitable position and rules have been made under section 81 which permit self-dealing under certain conditions and the retention of profits and benefits derived therefrom.[50]

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[46] *Ibid.*, para. 7.4. See para. 4.5.1, above.

[47] Para. 3.2.

[48] E.g. Wolman, "City Lobby fails to shake common law agency rules" Financial Times, 16 December 1985; Suter, *The Regulation of Insider Dealing in Britain* (1989), at 300; Lomnicka, "Curtailing Section 62 Actionability", [1991] J.B.L. 353, at 354 (s. 62 action does not preclude an action for breach of fiduciary duty); Powell and Lomnicka, *Encyclopaedia of FS Law*, para. 2-198; Rider, Abrams and Ferran *Guide to the FSA* (2nd ed., 1989), at 243; Poser, *International Securities Regulation* (1991), at 215. Cf. *Financial Services Law and Practice* (1987-92) (ed. Whittaker) I, para. 24.

[49] This power has been delegated to the SIB with certain exceptions; see para. 2.5.2, above.

5.3.5 Secondly, section 55 of the FSA empowers the making of regulations with respect to customers' money held by authorised persons. Section 55(2)(f) specifically empowers regulations to be made which authorise the retention by authorised persons "of so much of clients' money as represents interest", which would, in principle, otherwise be regarded as the customer's. The SIB Client Money Regulations provide for the payment of interest at a rate not less than the minimum deposit rate publicly offered by an approved bank with which any customer money held by the firm is deposited.[51] No sum of less than £20 for any six month accounting period is payable as interest; nor is interest payable on amounts under £10,000 held for less than ten business days.[52] The express statement in section 55(4) of the circumstances in which an institution with which a "client money bank account" is kept by an authorised person may be liable as constructive trustee where money is wrongfully paid from the account is a further indication that it was intended that rules made under section 55 can in principle alter the private law rights (whether at common law or in equity) of those dealing with an authorised person.[53]

5.3.6 The position of conduct of business rules made under section 48 is less clear. Although such rules necessarily affect relations between authorised persons and those doing business with them, and contravention of the rules is expressly[54] stated not to constitute a criminal offence, there is no express reference to non-statutory private law rights, whether arising in tort or in equity from a fiduciary or confidential relationship. The power given by section 48(1) is in general terms but only refers to rules "regulating the conduct of business", unlike the express reference in section 81 to the rights and obligations of third parties. The general rulemaking power in section 48(1) is supplemented[55] by specific authorisation for twelve kinds of conduct of business rule by section 48(2).

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[50] The Financial Services (Regulated Schemes) Regulations 1991, regs. 7-16(4-6, 9) and 8-05(3). Cf. The Financial Services (Regulated Schemes) Regulations 1991, reg. 7.12 which states that the regulatory duties of the manager and trustee are in addition to and not in derogation from duties under the general law so far as they are not restricted by the regulations.

[51] The Financial Services (Client Money) Regulations 1991, reg. 4.01. There is no liability to pay such proportion of the interest earned by the authorised person as is attributable to higher rates of interest on large sums on deposit. See also SIB, Consultative Paper 61, *Amendments to the Client Money Regulations* (March 1992).

[52] *Ibid.*, reg. 4.02.

[53] See *Paget's Law of Banking* (10th ed., 1989), (ed. Hapgood), at 36.

5.3.7 Many of the Core Rules[56] appear to derive their authority from the general provision in section 48(1) rather than the specific provisions of section 48(2). Not all of them cause substantial conflict with fiduciary obligations. For instance, although the policy underlying Core Rules 4 and 17, on polarisation, has been controversial, the effect of the requirement that a tied agent must initially disclose its status and the fact that it can only advise on a limited range of products, appears to limit the duties owed to the customer under the general law and hence the scope for conflict. We shall consider only the rules which respondents to our Questionnaire indicated raise practical issues of mismatch or conflict with fiduciary obligations.

5.3.8 First, Core Rule 2 states that where a firm has a material interest[57] in a transaction or a relationship which gives rise to a conflict of interest, "the firm must not knowingly[58] either advise, or deal in the exercise of discretion, in relation to that transaction unless it takes reasonable steps to ensure fair treatment for the customer". The issue is whether the "real sensible possibility of conflict" or any stricter test used in fiduciary law[59] is displaced in favour of a test concerned with the actual fairness of a transaction, with fairness sometimes ensured by the satisfaction of the best execution rule imposed by Core Rule 22.

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[54] FSA, s.62(4), on which see *Financial Services Law and Practice* (1987-92) (ed. Whittaker) I, para. 24.

[55] But without prejudice to the generality of s. 48(1): FSA, s. 48(3).

[56] The Core Rules referred to in this part are set out in Appendix 3.

[57] Defined in the Financial Services Glossary 1991, (2nd ed.), set out in Appendix 3.

[58] The meaning of this will depend on the ambit of Core Rule 36, concerning Chinese walls; see paras. 4.5.12-4.5.13, above, and paras. 5.3.16-5.3.22, below.

5.3.9 In the case of Core Rule 25, concerned with "front-running" (dealing for the firm's account in a relevant investment when the firm intends to publish a piece of research to customers before customers have had an opportunity to react to the research), it is not the rule itself which raises the possibility of conflict with fiduciary law but the fact that it is expressed to be subject to any exceptions contained in the rules of a SRO. Core Rule 25 provides that, subject to such exceptions, where a firm intends to publish a recommendation or a piece of research or analysis, "it must not knowingly[60] effect an own account transaction in the investment concerned or any related investment until the customers for whom the publication was principally intended have had (or are likely to have had) a reasonable opportunity to react to it".

5.3.10 SFA and IMRO permit "front-running", where the possibility of this occurring is disclosed in the publication.[61] Although the rules of the two SROs differ, it is also, broadly speaking, permitted where (a) the publication could not reasonably be expected materially to affect the price,[62] (b) the firm either deals to fulfil an unsolicited order[63] or is a recognised market maker and the transaction is effected in good faith in the normal course of market making,[64] or (c) no more is bought than is reasonably believed to be sufficient to satisfy anticipated demand and doing so will not cause the price to move "significantly"[65] or against the customers' interests by "a material amount".[66] Again, the issue concerns the displacement of the "real sensible possibility of conflict" test by one concerned with the fairness of the particular transaction, assuming, that is, that dealing in such circumstances would give rise to a "real sensible possibility of conflict".

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[59] See para. 2.4.9, above.

[60] Again the meaning of this will depend on the ambit of Core Rule 36, see n. 58 above.

[61] IMRO Chapter II Rule 3.12(3)(b) (research procured for firm's own purposes); SFA Rule 5-36(2)(e).

[62] SFA Rule 5-36(2)(a).

[63] SFA Rule 5-36(2)(c).

[64] SFA Rule 5-36(2)(b).

[65] IMRO Chapter II Rule 3.12(3)(a)(ii). There is also a disclosure requirement: Rule 3.12(3)(a)(iii).

5.3.11 Turning to the authorisation for specific kinds of rules in section 48(2), three of these are relevant in the present context.[67] The first is section 48(2)(c), concerning rules:

> "regulating the manner in which a person may hold himself out as carrying on investment business".

Core Rule 14 provides that customer agreements must set out "in adequate detail" the basis on which investment services are provided for private customers. In view of the doubts about the adequacy of the generalised advance disclosures of conflicts and possible conflicts which are common, the question is whether Core Rule 14, particularly when read in conjunction with provisions in the third tier rules, gives any form of legitimacy to what may not constitute adequate disclosure as a matter of private law.[68]

5.3.12 Section 48(2)(g) is more important. This authorises the making of rules which require:-

> "the disclosure of the amount or value, or of arrangements for the payment or provision, of commissions or other inducements in connection with investment business...".

The fact that authority is given for disclosure of *either* the "amount or value" *or* "of arrangements" is significant. The section appears to envisage rules which require the disclosure only of the *arrangements* for such payment or provision (not the amount or value) and which may not satisfy common law and equitable requirements which, as we have seen, may require full disclosure.[69] There is an express prohibition in section 48(3) on rules which limit the amount of value of commissions or other inducements.

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[66] SFA Rule 5-36(2)(d).

[67] S. 48(2)(i) (price stabilisation) is probably another; see Part 10 of the SIB Conduct of Business Rules.

[68] See para. 5.3.29, below.

5.3.13 Core Rule 18(2) provides that, subject to exceptions in the rules of a SRO, before a firm provides investment services to a private customer the "basis or amount" of its charges and the "nature or amount" of other remuneration must be disclosed. Core Rule 18(2) is subject to a number of exceptions in the new third tier rules.[70] Thus tied intermediaries are not under any obligation to disclose commission but, as part of "product disclosure", the Buyer's Guide explains that the intermediary will be paid by the company that issues the life policy or units.[71] The Core Rules do not yet apply to members of FIMBRA but its rules exempt members from disclosure in cases of execution-only customers where the transaction is effected by the member as principal or where the applicable customer agreement expressly relieves the member of the obligation.[72] Subject to this, they must disclose the fact that commission will normally be received at or before the time a recommendation is made and the amount if requested or in the product particulars sent after the point of sale, normally with the notice of the right to cancel.[73]

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[69] See para. 3.4.19, above. On the different issue of product disclosure, see Core Rules 9-12; SIB Retail Regulation Review, Discussion Paper 3, *Disclosure* (October 1991) SIB Retail Regulation Review, Consultative Paper 60, *Disclosure, Polarisation and Standards of Advice* (March 1992).

[70] LAUTRO Rules 5.14-15; IMRO Chapter II Rule 6.4; SFA Rule 5-33(3). See also SIB Retail Regulation Review, Discussion Paper 3, *Disclosure* (October 1991), para. 35; LAUTRO Rule 4.14 (disclosure obligation to investors who dealt through an independent intermediary and make request).

[71] SFA Rule 5-21(1) and Appendix 10; IMRO Chapter II Rule 6.2.

[72] FIMBRA rule 4.6.2.

[73] FIMBRA rules 4.6.1, 4.6.3(2)(b)(ii). See also SIB Retail Regulation Review, Discussion Paper 3, *Disclosure* (October 1991), para. 34; SIB Retail Regulation Review, Consultative Paper 60, *Disclosure, Polarisation, and Standards of Advice* (March 1992).

5.3.14 The overall position has been the subject of considerable criticism with the FSA regulatory bodies and the Office of Fair Trading taking different positions.[74] The SIB now considers that there must be "good disclosure of the effect of ... charges and expenses on the earning power of the investment made by the customer" by life offices at the point of sale[75] but is not proposing any changes to the position of independent intermediaries.[76] Where a fund manager receives goods or services ("soft commission") in return for an assurance that he will put not less than a certain amount of business through or in the way of a broker/dealer the obligation to disclose is stricter. Core Rule 3 prohibits this unless "adequate prior and periodic disclosure" is made.[77]

5.3.15 There are two issues. First, whether Core Rule 18(2) modifies the common law duties as far as private investors are concerned. The enabling power appears to permit this. Secondly, what is required for professional investors? While Core Rule 18(2) appears to sanction a different and lesser level of disclosure for private customers than that required at common law,[78] disclosure to other customers is, except in the case of soft commission,[79] not dealt with. What is one to make of this? On the one hand, in an area not covered by the rules the *prima facie* position is that the common law remains unchanged. On the other hand it seems unlikely that it was intended that *less* disclosure should be made to private customers than to professionals and both LAUTRO's and FIMBRA's rules indicate that this is the case.[80] If, however, Core Rule 18(2) modifies the common law, unless an effective contractual provision or a trade custom authorises less than full disclosure to professional customers, this may be the position. The rules in fact appear to assume that *greater* disclosure should be made to private customers but, unless the common law rules are to be altered by reference to the entirety of the rules and the assumptions in them rather than a specific rule,[81] this result will not be achieved.

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[74] Cf. Office of Fair Trading Report, *The Disclosure of Information about Life Insurance Products and Commissions paid to Independent Financial Advisers* (1990); SIB Retail Regulation Review, Discussion Paper 3, *Disclosure* (October 1991); SIB Retail Regulation Review, Consultative Paper 60, *Disclosure, Polarisation and Standards of Advice* (March 1992); LAUTRO Consultative Bulletin No. 11. *Disclosure* (1991); LAUTRO Consultative Bulletin No. 13, *Product Disclosure, Illustrations, Indirect Benefits and Other Matters* (March 1992).

[75] SIB Retail Regulation Review, Consultation Paper 60, *Disclosure, Polarisation and Standards of Advice* (March 1992), paras. 21-3.

[76] *Ibid.*, paras. 42-44.

[77] IMRO Rules II 1.7(3) and (4) (prior disclosure and annual disclosure of percentage and value of soft commission in relation to total commission).

[78] See para. 3.4.19, above.

[79] See para. 3.4.26, above.

5.3.16 In the present context, however, the rulemaking power contained in section 48(2)(h) is of greatest importance. This authorises the making of rules:-

> "*enabling* or *requiring* information obtained by an authorised person in the course of carrying on one part of his business to be withheld by him from persons with whom he deals in the course of carrying on another part and for that purpose *enabling* or *requiring* persons employed in one part of that business to withhold information from those employed in another part." (emphasis supplied).

This provision, which has been seen as a legislative indication of the legitimacy of Chinese walls for regulatory purposes,[82] also appears to envisage restrictions on disclosure which may not satisfy common law and equitable requirements.[83]

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[80] LAUTRO Rule 5.15(1)(a); FIMBRA Rules 4.25.2, 4.25.3(3).

[81] This is the situation envisaged in para. 5.1.3(i), above.

[82] E.g. Blair, *Financial Services The New Core Rules* (1991), at 137; Poser, *International Securities Regulation* (1991), at 207-209, 212-213, 215-221; Suter, *The Regulation of Insider Dealing in Britain* (1989), at 300. See also the Licensed Dealers (Conduct of Business) Rules 1983 S.I. 1983/585 rules 2 and 8; Section 4.5, above.

[83] As to which, see paras. 3.4.29-3.4.31, above.

5.3.17 Core Rule 36, tracking the language of section 48(2)(h), deals with the withholding of information by Chinese walls. As we have seen,[84] it does two things. First it authorises the withholding of information by one part of a firm's business from another part separated from it by a Chinese wall. Secondly, it provides that knowledge will not be attributed within different parts of a corporate entity where, as in Core Rule 2, the Core Rules require knowledge and, for the purpose of criminal liability under section 47 in respect of misleading statements and practices. The question is whether it has effected a limited modification of the common law duty of disclosure pursuant to the "undivided loyalty" rule[85] and the current law on attribution of knowledge within one entity.[86]

5.3.18 Sections 48(2)(g) and (h) thus directly contemplate restrictions on disclosure to third parties including customers to whom duties of disclosure would otherwise be owed. It is arguably artificial to interpret them as only authorising the regulator to replicate the non-disclosure permitted by general equitable principles in the regulatory rules. One possible justification for this interpretation is that the regulator can prohibit firms from excluding the rules even if at common law such exclusion would be permitted by disclosure and consent. If that was what the legislature intended it could have been done more directly, and the rules made by the SIB under sections 48(2)(c), (g) and (h) do not seek to replicate the common law as other rules do.[87] However, if those provisions do authorise rules providing for non-disclosure where the general law governing fiduciaries and intermediaries requires it, the question arises as to the permissible scope of the rules made under them.

5.3.19 It might be argued that the two sets of rules (regulatory rules and the general law) simply operate in separate spheres. On this approach rules made under sections 48(1) and 48(2)(c),(g) and (h) operate at the regulatory level and the latter only permit a lower level of disclosure than would be required by the general law for regulatory purposes. In the case of section 48(2)(g) it is possible to satisfy both the lower regulatory requirement (e.g. disclosure of arrangements for commission but not amount) and the more extensive requirement of the general law (e.g. disclosure of the amount of commission), and the "separate spheres of operation" argument may be attractive. There is no necessary conflict in the sense that compliance with one duty would necessarily be a breach of the other duty. On the other hand such an approach might be thought to lead to confusion as to what is required.

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[84] Paras. 4.5.12 to 4.5.13, above.

[85] See para. 2.4.9(iii), above.

[86] See Section 2.3, above.

[87] See Core Rules 20-27.

5.3.20 The "separate spheres of operation" argument is, however, less attractive when applied to section 48(2)(h). This uses the words "enabling" and "requiring" in relation to the withholding of information, and acceptance of separate spheres of operation would involve a direct conflict of duties. As a firm cannot be "enabled" to withhold information if it is in any event free to do so, it can be argued that the sub-section must be concerned with a situation in which there is an existing common law or equitable duty of disclosure. If this is correct, unless the section empowers the modification of such duty, a firm would not be "enabled". In the case of a regulatory "requirement" to withhold information it would be subjected to conflicting duties because withholding as "required" by the rules would necessarily constitute breach of common law or equitable duties to disclose that information, while disclosure to satisfy the general law would necessarily involve breach of the regulatory "requirement".[88] For this reason, it might be said that section 48(2)(h) should be interpreted to authorise rules modifying duties of disclosure under the general law.

5.3.21 Another factor to take into account when evaluating the "separate spheres of operation" argument is that, by FSA, section 48(6), compliance with rules made under 48(2)(h) is a defence to a criminal charge under section 47 for inducing an investment agreement through misleading statements and deceptive and manipulative practices (including dishonest concealment). To this extent it is clear that the rules have an effect beyond the regulatory scheme. It is arguable that this effect is confined to the criminal law and that there might nevertheless be civil proceedings for misrepresentation or breach of an equitable duty to disclose. It would, however, be odd if that which was required to avoid two kinds of liability (i.e. criminal and regulatory), nevertheless automatically involves exposure to another kind of liability (i.e. for breach of common law or equitable duties).

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[88] It is possible to interpret "requiring" to mean "requiring where permitted to do so by fiduciary law", but see para. 5.3.18, above.

5.3.22 Finally, if section 48(2)(h) does provide authority to modify common law and equitable duties, it is arguable that so does the general rulemaking power in section 48(1). By section 48(3), the particular powers in section 48(2) are without prejudice to the generality of section 48(1), and it is surely arguable that if the particular rulemaking powers give authority to modify duties owed to third parties under the general law so does the general rulemaking power. This has implications for those market practices which the rules assume to be, but do not explicitly make legitimate, including "best execution" as a way of handling material interests and generalised advance disclosure of the capacities in which a person may be acting and that he will be paid commission.

Self-Regulating Organisations

5.3.23 Several commentators, including the SIB's first chairman,[89] appeared to favour an exclusively contractual - i.e. private law - approach to systems of non-statutory self-regulation. At the time the Financial Services Act came into force it was not clear whether the statutory backing given to SROs meant that they would be regarded as operating in the public law sphere for all purposes. One area of doubt concerned their amenability to judicial review. However, the *Take-Over Panel case*[90] clarified the matter and there now seems little doubt that they are. Proceedings by way of judicial review have been brought against SROs and, although the jurisdiction point does not appear to have been taken,[91] this is surely correct.

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[89] Sir Kenneth Berrill, "Supervising the New City", (1986) 83 Law Soc. Gaz. 434, 442. See also 97 H.C. Deb. 205W; Page, "Self-Regulation: The Constitutional Dimension", (1986) 49 M.L.R. 141, 146-7.

[90] *R.* v. *Panel on Take-Overs and Mergers, ex p. Datafin Plc* [1987] Q.B. 815, para. 5.2.3, above.

5.3.24 The SROs are an integral part of the FSA's scheme of regulation. The power of SROs to admit and expel members has the important consequence of granting and revoking authority to carry on investment business under the Act and most persons are in fact authorised by their membership of such SROs. A SRO can modify certain core rules designated by the SIB to apply to its members or grant dispensation from the rule where adherence is unduly burdensome and there is no undue risk to investors.[92]

5.3.25 As in the case of the SIB, the statute gives SROs immunity from damages in respect of bona fide regulatory action,[93] and exemption from mainstream United Kingdom competition legislation.[94] Although the Companies Act 1989 provides that the remedy to enforce a direction that a SRO change its rules is an injunction[95] originally the FSA provided that it was to be the prerogative order of mandamus,[96] a remedy for the enforcement of public duties.[97] Again, all those subject to the rules of a SRO are authorised whether or not they are members[98] so the effect of the rules goes beyond the parties to the contract of membership. The Core Rules and the third tier SRO rules operate in an integrated way, for instance, by the development of exceptions to the Core Rules in the third tier rules as is shown by the rules concerning disclosure and front running considered above.[99] Thus, a duty or liability owed to a customer under a SRO rule is a duty under the regulatory system which, under Core Rule 15(1), cannot be excluded or restricted.[100] Again, the SIB's power to restrain the contravention of regulatory rules by injunction extends to SRO rules.[101]

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[91] *Bank of Scotland* v. *I.M.R.O.* [1989] S.L.T. 432 (see also *Watt* v. *Strathclyde R.C.* (Lord President 10 July 1991)); *R.* v. *FIMBRA, ex p. Cochrane* [1990] C.O.D. 33; *R.* v. *LAUTRO, ex p. Ross* [1992] 1 All E.R. 422; *R.* v. *A.F.B.D., ex p. Mordens Ltd.* [1991] C.O.D. 40.

[92] FSA, s. 63B, inserted by Companies Act 1989, s. 194.

[93] FSA, s. 187(1).

[94] FSA, ss. 124-126.

[95] FSA, s. 13(3), as amended by Companies Act 1989, s. 206 and Sch. 23 para 1.

[96] FSA, s. 13(3), before the 1989 amendments.

[97] *de Smith's Judicial Review of Administrative Action* (4th ed., 1980), at 540; Wade, *Administrative Law* (6th ed., 1988), at 649.

[98] FSA, ss. 7 and 8(2).

5.3.26 On this reasoning, the rules of SROs are instruments of public law and the status of valid SRO rules is in principle the same as that of rules of the SIB. However, courts might approach SRO rules in a different way from the rules of the SIB. Although, as explained in paragraph 2.5.12 the contents of a SRO's rules must satisfy the requirements of Schedule 2 if it is to be recognised, SROs are not expressly given rulemaking powers by the FSA. It was assumed that they would operate contractually. The consequence is that it is not, therefore, possible to apply ordinary principles of statutory vires in the same way as in respect of the SIB's rules, and the issues considered above concerning the construction of FSA sections 48, 55 and 81 do not arise. But the capacity of SROs, which are limited companies, is limited by their objects.[102] The limitations upon a SRO's *capacity* are, accordingly, to be found in its own constitution. However, because of their public law status, unlike other limited companies, control over capacity can be by way of an application for judicial review.[103] Furthermore, the fact that valid rules are instruments of public law means that even if they, unlike the SIB's rules, do not derive from a statutory source, they are likely to be given a similar effect to other public "quasi-legislation".[104]

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[99] Paras. 5.3.12-5.3.15 and 5.3.9-5.3.10, above.

[100] See the definition of "regulatory system" in the Financial Services Glossary 1991 (2nd ed.) set out in Appendix 3; and Blair, *op. cit.*, at 91.

[101] FSA, s. 61(1)(a)(iv) albeit as qualified by s. 61(2) - inability or unwillingness of SRO to restrain contravention.

[102] Whereas the objects of SFA, IMRO and LAUTRO are closely linked to being an authorised SRO under the FSA and the requirements of Sch. 2, those of FIMBRA are, (a) to regulate, for the purpose of the protection of investors, the carrying on of investment business by or on behalf of members (b) to regulate the carrying on in connection with investment business of any other business, or of any other business held out as being for the purposes of investment (c) to represent the interests and views of members.

[103] As there are such limiting objects control may be more extensive than in the case of the Take-Over Panel, an unincorporated association without legal personality. See the comments of Sir John Donaldson M.R. in *R.* v. *Panel on Take-Overs and Mergers, ex p. Datafin Plc.* [1987] Q.B. 815, 841.

5.3.27 In some contexts, such as rules concerning fair allocation and churning and switching,[105] the matter is left to the Core Rule, and there is nothing to add at this stage. Where SRO rules have been made, again we concentrate on the ones which respondents to our questionnaire consider may conflict with fiduciary obligations. Our provisional conclusions will be found in the "Analysis" section of this chapter.

5.3.28 First, there are the rules concerning disclosure and front-running, which are discussed together with the relevant Core Rules since the SROs are given power to make exceptions from the Core Rules.[106] In view of the policy of the FSA and the integrated way it envisages the rules of the SIB and SROs will work, with express authority to leave the formulation of exceptions to SROs[107] there is no question of this constituting an improper sub-delegation of power.[108]

5.3.29 Secondly, there are the rules concerned with dual agency and self dealing, which are dealt with by Core Rule 2. This prohibits knowingly advising or discretionary dealing where a firm has a material interest in a transaction unless the firm "takes reasonable steps to ensure fair treatment for the customer". FIMBRA's rules permit dual agency and self dealing where the customer has consented to the particular transaction with full knowledge of the circumstances, or where the customer agreement "confers authority on the member to transact investment business in the relevant manner without particular reference to the client".[109] SFA Rule 5-29(2) states that a firm may take reasonable steps to ensure fair treatment for the customer by relying on an independence policy and specifies the requirements for an effective independence policy.[110] In relation to Core Rule 14 on customer agreements, SFA Table 5-23(4)(b) states that two-way customer agreements should include, where applicable, a statement of the basis by which the firm may receive remuneration from another person in connection with the customer's transaction, and a statement that the firm intends to hold customer money in an approved bank which is in the same group as the firm. We have already been seen that Core Rule 2 raises the question of the displacement of the "real sensible possibility of conflict" test used in fiduciary law in favour of one concerned with the actual fairness of the transaction.[111] Another question is whether, where common law requires consent with full knowledge of the circumstances, SRO rules validating generalised advance disclosure of possible conflicts and consent to them or to their being handled by an independence policy, may alter the general law.

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[104] See in general Ganz, *Quasi-Legislation: Recent Developments in Secondary Legislation* (1987), ch. 2.

[105] I.e. dealing too frequently in the circumstances or switching within a packaged product or between packaged products, on which see Core Rules 24 and 26.

[106] Paras. 5.3.11-5.3.15 and 5.3.9-5.3.10, above.

[107] FSA, s. 63A(2), inserted by Companies Act 1989, s.194.

[108] *Blackpool Corporation* v. *Locker* [1948] 1 K.B. 349. See generally, Wade, *Administrative Law*, (6th ed., 1988), at 357-360, 874.

(ii) **Legal Services**

Solicitors

5.3.30 Our concern is with those rules promulgated by the Law Society which affect the rights and duties of solicitors and their clients,[112] and the impact of those rules on such rights and duties.

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[109] Rule 4.14.1. This is subject to a number of exceptions, including transactions relating to life policies, pensions contracts, and those with clients who carry on investment business or are professional investors; Rules 4.14.2.

[110] See paras. 3.4.32 and 4.4.1-4.4.2, above for discussion of independence policies.

[111] See para. 5.3.8, above.

[112] The Solicitors' Practice Rules 1990, The Solicitors' Accounts (Deposit Interest) Rules 1988 (with effect from 1 June 1992 these will be consolidated into the Solicitors Accounts Rules 1991). The Solicitors' Investment Business Rules 1990, and The Solicitors' Introduction and Referral Code 1990 (promulgated under r. 3 of the Solicitors' Practice Rules 1990).

5.3.31 The Law Society is required to make rules governing the opening and keeping of bank or building society accounts for client money[113] and to require a solicitor either to keep money received on account of a client in a separate account or to pay the client a sum "equivalent to the interest which would have accrued if the money so received had been so kept on deposit".[114] By section 33(3) a solicitor is not liable, except as may be provided by the rules,[115] to account to clients for interest received by him on client money deposited in the general client account. Under the rules interest is only payable on money held for a client in the general client account, if it is a sum equal to or exceeding certain specified minimums being held for the appropriate specified minimum period, or longer.[116] Section 33(3) and the rules clearly alter the common law duty of the solicitor not to profit from use of his clients' money.[117] However, this is based on a clear and express statutory provision.

5.3.32 The Law Society is also empowered to make rules on professional conduct and discipline[118] and professional indemnity.[119] However, the responses to the Issues Questionnaire[120] suggested that solicitors encounter few problems arising out of discrepancies between the rules of the Law Society and their common law fiduciary duties. For the most part, the rules and duties are concordant,[121] and such conflicts that exist are very minor.[122] Even where a solicitor carries on investment business under authorisation by the Law Society there is little scope for conflict between the rules and fiduciary duties. The solicitor is still subject to the strict Solicitors' Practice Rules,[123] and the only rule which may impact on the private law rights of his client is that which excludes the regulatory duty to take into account or disclose relevant information to a client where that would amount to a breach of duty to another person.[124]

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[113] Solicitors Act 1974, s.32.

[114] Solicitors Act 1974, s.33(1). See, in relation to financial services, para. 5.3.5, above.

[115] *Ibid.*, s.33(3). The current rules are the Solicitors' Accounts (Deposit Interest) Rules 1988 made by the Law Society, but see n. 112, above.

[116] Rule 3. By rule 4, interest is to be at a rate not less than that advertised by the relevant bank/building society for small deposits subject to the minimum period of notice of withdrawals.

[117] *Brown* v. *I.R.C.* [1965] A.C. 244.

[118] Solicitors Act 1974, s. 31.

[119] *Ibid.*, s. 37.

[120] See Appendix 1.

[121] See, for example, Solicitors' Practice Rules 1990, r. 1., Solicitors' Introduction and Referral Code 1990, ss. 1, 2(4) and 2(5) and the non-statutory principles 9.06, 11.01, 11.02, 11.03, 11.05, (conflicts of interest), and 9.13, 12.01, 12.03, (confidentiality), (The Law Society, *The Guide to the*

5.3.33 The Law Society's rules only permit the use of Chinese walls to manage a conflict of interest in one very limited case. This is where there has been an amalgamation of two firms of solicitors, but even then the general rule is that the new firm must cease acting for both clients. The use of a Chinese wall is permitted by the Law Society's Guidance only where (a) *both* clients have, after obtaining "full and frank independent advice", consented to the new firm acting and, (b) the overriding duty to act in the best interests of the client(s) demands, as a rare exception to the general rule, that the new firm continue acting despite the conflict of interest.[125] However, the Guidance also states that the difficulties in maintaining the requisite separation, and the risk of impropriety are so great that the firm can virtually never act for both and invariably not in litigation.[126] Although a Chinese wall erected pursuant to the Law Society's Guidance has not been considered by the courts, in *Lee (David)*

Professional Conduct of Solicitors (1990)).

[122] See, for example, The Solicitors' Practice Rules 1990, r. 6(2), (a solicitor may act for certain categories of connected parties on a transfer of land or grant of lease provided certain conditions are satisfied and no conflict of interest appears); r. 10(1), (a solicitor must account to his client, unless he has made appropriate disclosure, for commissions exceeding £10. But it should be noted that this rule does not specifically entitle the solicitor to retain sums of £10 or less without disclosure). On the very limited circumstances in which the rules permit the use of Chinese walls, see below.

[123] Solicitors' Investment Business Rules 1990, r. 3(3).

[124] Solicitors' Investment Business Rules 1990, r.9 (4). This exclusion is restricted to the regulatory duty to disclose and does not purport to exclude the fiduciary duty to disclose. Unless the duties set out in the Investment Business Rules replace the fiduciary duties which would otherwise apply, which it is thought they do not, this rule will not affect those duties.

[125] Guidance on Conflict Arising on the Amalgamation of Two Firms of Solicitors, *Guide to the Professional Conduct of Solicitors* (1990), Appendix C15. para. 2; Solicitors' Practice Rules 1990, r.6.

[126] *Ibid.* para. 8.

& Co (Lincoln) Ltd. v. *Coward Chance*,[127] discussed in paragraph 4.5.9, above, Browne-Wilkinson V.-C said of the Law Society rules that "to the extent that the rules ... are inconsistent with and do not comply with the general law, then they would obviously be improper".

5.3.34 The relationship between Law Society rules and private rights was, however, considered in *Swain* v. *Law Society*.[128] The case involved the power under the Solicitors Act 1974, section 37 to make rules concerning indemnity for losses arising from liability for professional negligence, a power very similar to that in the FSA, section 53. The Law Society chose to do this by rules authorising the taking out and maintaining of a master insurance policy and requiring solicitors to pay the premiums. The Law Society and its sole brokers agreed to share the commission received from insurers and the plaintiff sought a declaration that the Society was under a duty to account to individual solicitors for commission received. It was held that individual solicitors had directly enforceable rights under the policy and were subject to the duties of an assured under an insurance policy. However, there was no duty to account. An argument that the Law Society had contracted as agents failed because some of the supposed principals would be unascertained when the master policy contract was made. Similarly, it was held that the Law Society was not a trustee; it had not expressly made itself such and the court held that it was not possible to imply a trust. Solicitors were accordingly deprived of the freedom to negotiate their own insurance cover and bargain for a share of the brokers' commission as part of a regulatory scheme, but were given rights under contracts to which they were not parties.

5.3.35 In a purely private law context a trust or agency relationship and thus a duty to account might well have been found, perhaps by recourse to one of the "juristic subterfuges"[129] which courts have used to mitigate the non recognition in English law of a third party's rights to sue on a contract made for his benefit. However, no such duty in fact arose because, in the exercise of its rulemaking powers, the Law Society was acting in a public capacity. Thus, by an exercise of a public law rulemaking power, rights were created between the regulated solicitor and the insurer. Although *Swain's* case itself concerned the relationship between the regulator and the regulated rather than that between the regulated and their customers, it is significant that the statute was silent as to the impact of the rulemaking power on private rights should the Society choose to exercise its regulatory power by requiring solicitors to use it as an intermediary in contracting with insurers.

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[127] [1991] Ch. 259, 266. In that case neither party had consented. See also the discussion in paras. 4.5.7-4.5.10, above.

[128] [1983] 1 A.C. 598.

[129] *Ibid.*, 611, per Lord Diplock.

Barristers

5.3.36 It is clear that rules and decisions of the Bar Council operate in the public law sphere.[130] However, there appears to be little scope for conflict between the duties of barristers under the general law and those owed under the Code of Conduct.[131] As barristers in independent practice are required to be sole practitioners, even though they practise in chambers with others, the difficulties produced by the rules on attribution of knowledge within a corporate entity or partnership do not arise and we received no comments on practices of barristers such as that members of the same chambers may appear for different parties in the same matter.

(iii) **Insurance Services**

The Council of Lloyds

5.3.37 The Lloyd's Act 1982 confers upon the Council of Lloyd's the power to "regulate and direct the business of insurance at Lloyd's ...... in accordance with and subject to the provisions of Lloyd's Acts 1871 to 1982 ...".[132] In its position as the regulator of a large section of the UK insurance market, it is clear that the Council is a public law body,[133] carrying out public law functions.[134] Although the potential scope for conflicts between regulatory rules and fiduciary duties is probably as wide in this context as in other financial services, no attention was drawn to any particular problems by the replies to the Issues Questionnaire. One example of a problem that may arise in the future is the conflict of interests that can occur if brokers have an interest in managing agents and vice versa.[135] This practice was prohibited by Sections 11 and 12 of the Lloyd's Act 1982, but the recent report, "Lloyd's: A Route Forward", suggests that this prohibition should be lifted, arguing that the current regulatory structure provides sufficient safeguards.[136] If this prohibition were to be lifted and the Council were to alter the byelaws and regulations so as to allow such a practice, this would be another example of a conflict between regulatory rules and fiduciary duties. The resolution of the conflict would then again depend on the interpretation of the enabling power, which in this case is to "regulate and direct the business of insurance at Lloyd's".[137]

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[130] *R.* v. *General Council of the Bar, ex p. Percival* [1991] 1 Q.B. 212. On the Inns of Court, see *R.* v. *Benchers of Gray's Inn* (1780) 1 Doug. 353; *Lincoln* v. *Daniels* [1962] 1 Q.B. 237, 250 (position as if disciplinary power derived from statute).

[131] See para. 2.5.15, above.

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[132] Lloyd's Act 1982, s. 6(1).

[133] The Council was the subject of judicial review proceedings in *R.* v *Council of the Society of Lloyd's, ex p. Carpenter*, The Times 22 August 1984; see also *R.* v *Committee of Lloyd's, ex p. Posgate*, The Times 12 January 1983.

[134] Lloyd's is exempt from the public law regulation of insurance companies contained in Part II of the ICA and the FSA. The Council provides by-laws and rules for the regulation of matters that would have been covered by these acts.

[135] See paras 2.5.17-18, above. See also paras 3.2.17-18, above.

[136] Report of the Task-Force (1992), para 13.57.

[137] See n. 132, above.

Insurance Brokers Registration Council

5.3.38 In accordance with the IB(R) Act, the IBRC has produced a code of conduct,[138] rules regarding the requirements for carrying on business,[139] and rules on professional indemnity.[140] None of the responses to the Issues Questionnaire raised any problems of conflict between the IBRC code of conduct or rules and fiduciary duties. The code of conduct provides little room for conflict with fiduciary duties since Section 10 of the IB(R) Act states that the code of conduct "shall serve as a guide ..... the mention or lack of mention in it of a particular act or omission shall not be taken as conclusive of any question of professional conduct". From this it is clear that the code does not act to alter any of the fiduciary duties owed by a broker to his customer. In any event the code of conduct complements brokers' fiduciary duties, one of the three fundamental principles being that:

> "Insurance brokers shall do everything possible to satisfy the insurance requirements of their clients and shall place the interests of those clients before all other considerations. Subject to these requirements and interests, insurance brokers shall have proper regard for others."

(iv) **Property Services**

Council for Licensed Conveyancers

5.3.39 The Council for Licensed Conveyancers, in accordance with Section 20 of the Administration of Justice Act, has produced rules for "regulating the professional practice, conduct, and discipline of licensed conveyancers."[141] There is no reference in the statute as to the relationship of the rules made under this power and any common law or equitable requirements. The current rules[142] would, however, appear in general not to produce conflicts with fiduciary duties. As with the IBRC, one of the principles is that "A licensed conveyancer shall place the interests of his client in relation to any transaction before his own".[143] The rules also provide for the protection of confidential information,[144] and a duty of disclosure of all profits arising directly or indirectly from any transaction.[145] Such requirements are in accordance with accepted fiduciary principles. However, the Law Society, in its response to the Issues Questionnaire, queries whether Rule 22 is in accordance with the general law. Rule 22 states:

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[138] In accordance with s. 10 of the Act. The Code was approved by the Insurance Brokers Registration Council (Code of Conduct) Approval Order 1978, SI 1978/1394.

[139] In accordance with s. 11 of the Act. Rules were approved by the Insurance Brokers Registration Council (Accounts and Business Requirements) Rules Approval Order 1979, SI 1979/489 as amended by SI 1981/1630.

[140] In accordance with s. 12 of the Act. Rules were approved by the Insurance Brokers Registration Council (Indemnity Insurance and Grants Scheme) Rules Approval Order 1987, SI 1987/1496 as amended by SI 1990/2461.

> "(2) In particular a licensed conveyancer must not act for:
>
> (a) both parties to a transaction save where it appears that there is no conflict of interest between the parties and both have consented in writing:-
>
> (i) to his acting; and
>
> (ii) to his ceasing to act for either party should a conflict of interest subsequently arise;"

In relation to solicitors, the Law Society rules on this point "recognise that the likelihood of a conflict between a seller and buyer of land is such that in general a conveyancer should not act for both parties even where both parties consent to his so acting".[146] In Section 3.4 we have seen that specific disclosure in writing may displace the fiduciary duties inherent in a relationship. Thus Rule 22 does not conflict with the general law because it requires consent.

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[141] All rules made under this section are to be made with the concurrence of the Lord Chancellor (s.38).

[142] The Council for Licensed Conveyancers' Rules of Conduct, Practice and Discipline 1989. New draft rules are currently being considered by the Lord Chancellor.

[143] *Ibid.* rule 4(c).

[144] *Ibid.* rule 29.

[145] *Ibid.* rule 36.

[146] Para. 6.3 *Fiduciary Duties and Regulatory Rules - Response to the Law Commission's Issues Questionnaire in relation to Solicitors*, The Law Society, February 1991.

It would appear that the mismatch is between the Law Society rules and the general law, the Law Society rules being stricter than the general law requirements. This issue does, however, demonstrate the possibility of mismatch between the rules governing licensed conveyancers and the general law. Section 20 states only that rules as to conduct should be made in pursuance of its general duty under Section 12(2). This general duty is merely that the standard of conduct of licensed conveyancers is "sufficient to secure adequate protection for consumers", and, as such, leaves open the possibility that rules may be made which do not provide a similar standard of protection to that given by the imposition of fiduciary duties by the private law.

Authorised Conveyancing Practitioners Board

5.3.40 The Lord Chancellor has announced that the introduction of authorised conveyancing will be suspended for the time being due to insufficient demand.[147] We do not, therefore, propose to comment on the draft regulations circulated by the Lord Chancellor's Department,[148] but shall briefly consider whether the powers given to the Lord Chancellor to make regulations in relation to authorised conveyancing practitioners allow such regulations to modify common law fiduciary duties. The Courts and Legal Services Act 1990 gives the Lord Chancellor the power to make regulations regarding conduct and competence,[149] and provides that the regulations may make provisions "designed to avoid conflicts of interest",[150] and "as to the disclosure of and accounting for commission".[151] The power to make regulations "designed to avoid conflicts of interest" does not appear susceptible to an interpretation which would allow such regulations to modify common law fiduciary duties. Regulations can only be made to *avoid* conflicts, and any rule which allowed a practitioner to act where there was a conflict of interest at common law would not modify the relevant fiduciary duty. However, it is unclear whether the power to make provisions as to the disclosure of commission enables the Lord Chancellor to make regulations which displace the common law requirements, or whether it merely allows the regulations to replicate or require additional disclosure to that necessary to satisfy common law requirements. This uncertainty is unlikely to cause a "real" conflict[152] between the regulatory and common law disclosure requirements, but does raise the question of whether, if the regulations were to require a lower level of disclosure than that which would be necessary at common law, compliance with the regulations would provide a "safe harbour" against allegations of breach of fiduciary duty.

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[147] 536 H.L. Deb. 71-72W.

[148] *The Draft Authorised Practitioner Regulations (Section 40 of the Courts and Legal Services Act 1990), A Consultation Document*, April 1991.

[149] S. 40.

[150] *Ibid.*, s. 40(2)(d).

[151] *Ibid.*, s. 40(2)(h).

(v) Accountants

5.3.41 Where accountants' practices are regulated by statute,[153] their professional bodies are generally required to make rules complying with statutory requirements for the regulation of training, qualification, conduct, and practice.[154] In the responses to the Issues Questionnaire no conflicts between the rules of professional bodies and fiduciary duties were mentioned. It should be noted, however, that the general approach to regulation of conduct is the enforcement of independence policies and, as mentioned above,[155] the effect of such policies is to manage conflicts rather than to eliminate them. As no statutory power has been given to the professional bodies to modify common law rights (either expressly, or impliedly),[156] these policies will not eliminate the breaches of duty that may occur within an accountancy firm.

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[152] See para. 1.13, above.

[153] See para. 2.5.28, above.

[154] For example, the requirements for recognition as a RSB for auditing purposes are set out in Companies Act 1989 Sch. 11, Part II. See para. 2.5.28, n. 200, above.

[155] Paras. 4.4.2-4.4.3, above.

[156] Sch. 11, Part II, Para. 7(1)(b) of the Companies Act 1989, requires that RSBs have adequate rules to ensure that persons are not appointed as company auditor in circumstances in which they have any interest likely to conflict with the proper conduct of the audit.

5.4 Analysis

5.4.1 As indicated, the impact of the rules made under the regulatory systems on the common law and equitable rights and duties of those subject to regulation and their customers depends on two factors. First, there is the question of the regulators' authority to make rules altering such rights. In the case of the FSA we believe that the rulemaking powers concerning clients' money and unit trusts provide two reasonably clear examples of authorisation.[157] We also incline to the view that section 48(2)(h) authorises rules modifying common law and equitable duties to the customer to disclose or to make use of relevant information where a Chinese wall is used.[158] Secondly, if there is such authority, the question is whether the regulators have in fact exercised it when making their rules. As the responses to the Issues Questionnaire indicated that the problems primarily concern financial services, the focus of this section is on that area. Since the fundamental purpose of the FSA scheme and the fundamental purpose of fiduciary duties are investor and beneficiary protection through prophylactic rules, it is not likely that the regulators would wish to make radical alterations to fiduciary duties. What is more likely is a restatement or an attempt to refine the requirements of a fiduciary duty in a given context in the light of the totality of the safeguards for investors under the regulatory scheme. An example of restatement is provided by Core Rules 20-27.[159] An example of refinement is provided by the unit trust schemes rules, where the clear authority to modify equitable duties was exercised without covering the whole range of duties under the general law.

5.4.2 Where a rule is made which appears to conflict with or modify fiduciary duties there are three possible outcomes. First, the court might hold that there is no authority to make such a rule and invalidate it. Secondly, the court might give the rule a restrictive interpretation so that it (a) does not affect common law and equitable duties, or (b) only operates in the regulatory sphere. Thirdly, the court might recognise that the rule is made pursuant to statutory authority in one of two ways. First, it might conclude that there is authority to modify common law and equitable rules. If so, the regulatory rule will have statutory force and the same effect as if it was in the statute,[160] including the modification of the common law or equitable rule with which it conflicts. The common law or equitable rule is subsumed by the regulatory rule which will be valid unless it is set aside in judicial review proceedings. However, even where a court concludes that a regulatory body has no authority dispositively to modify common law and equitable duties, it can give some recognition to the public law nature of the regulatory rules by taking account of them in ascertaining the precise content of the common law or equitable obligation. Here, the public law validity of the rule makes it a relevant (although not conclusive) factor in the determination of the content of the common law or equitable rule in that particular context.

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[157] See paras. 5.3.4-5.3.5, above.

[158] See paras. 5.3.16-5.3.21, above.

[159] These are concerned with customer order priority, timely execution of orders, best execution, timely and fair allocation of orders, dealing ahead of publications, churning and switching, and derivatives transactions, see Appendix 3.

5.4.3 The approach taken will, of course, depend on the statutory context and the extent of the particular rulemaking power. There may be different outcomes for different parts of the same statute. In the case of the FSA, while we believe there is statutory authority for regulatory rules under sections 55, 81 and probably 48(2)(h) to modify common law and equitable obligations, the position of other sections is less certain. We have seen that SROs are not expressly given rulemaking powers by the FSA. For this reason, their rules, while instruments of public law and recognised by the FSA as operating in an integrated way with the SIB's rules,[161] may not be "statutory" rules with statutory force[162] and may thus technically differ from the SIB's rules. The source of any power to affect common law rules would have to be in the combined effect of the objects of SROs,[163] satisfaction of the recognition criteria in FSA Schedule 2 and the fact that a particular SRO has been recognised by the SIB. This is, of course, far less visible and direct than the source of the SIB's power.

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[160] Bennion, *Statutory Interpretation* (1984), at 133-135.

[161] See para. 5.3.25, above.

[162] See para. 5.3.26, above.

[163] See para. 5.3.26, above.

In principle, however, the public law nature of rules of SROs and the fact that the third tier SRO rules operate in an integrated way with the Core Rules may mean that the court is able to take a similar approach to their interpretation as it does to the SIB's rules.

5.4.4 The presumption that statutes do not alter the common law applies where statute accords power to public bodies.[164] As in other contexts, however, where the statute is not clear, the court's determination of which of the options set out above applies in the case of a particular rulemaking power may well depend on the strength of the presumption which varies according to the context. At one end of the spectrum, where the interference is with personal liberty or property rights, it is strong. However, it has been said to be weaker in the case of modern statutes, particularly those establishing a sophisticated regulatory scheme.[165] For instance, the regulation of lawyers and accountants is less circumscribed by statute than the regulation of investment business under the FSA. The Law Society's rulemaking powers under the Solicitors' Act 1974 are, save in the case of client money, very general and the statute does not contain detailed provisions as to what the rules should contain or are expected to achieve, by contrast with the treatment of the powers of the SIB and SROs in the FSA. For convenience, the differing strengths of the presumption that statutes do not alter the common law will be examined by considering three models.

5.4.5 Where the presumption is strongest, "special" regulatory law will be subject to "general" principles of private law unless the common law principles are necessarily overridden by the statute. Under this "private law model" there is no authority to make rules altering such rights and obligations save where the enabling statute gives it expressly or by necessary implication. If there is no such authority, "[t]o the extent that the rules ... are inconsistent with and do not comply with the general law, then they would obviously be improper".[166]

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[164] *Mixnam's Properties Ltd.* v. *Chertsey U.D.C.* [1965] A.C. 735, 750-752 (no power in local authority to restrict, by conditions in site licence, site owners' freedom of contract with licensees on matters not relating to use of the site). Bylaws, moreover, must not be repugnant to the common law unless expressly authorised by their enabling Act: *Torquay Local Board* v. *Bridle* (1882) 47 J.P. 183; *Collman* v. *Mills* [1897] 1 Q.B. 396 (although a general regulatory power was held to authorise a strict liability offence); *White* v. *Morley* [1899] 2 Q.B. 34, 39; *Powell* v. *May* [1946] K.B. 330.

[165] Bennion, *Statutory Interpretation* (1984), at 304-305. See also in a different context *B.* v. *Forsey* 1988 S.L.T. 572.

5.4.6 Where the presumption is weakest, the facilitative aspects of the statute assume more importance. Under this "public law model" it is the nature and scope of the statutory scheme rather than an express power to alter private law rights in the rulemaking powers that is important in determining the scope of the rulemaking powers. The Court will take into account whether the rulemaking authority is accompanied by "checks or safeguards".[167] Although it might be *Wednesbury* unreasonable[168] or incompatible with statutory purposes for a rule to alter common law rights, this should be deduced from the words of the statute itself.[169]

5.4.7 A middle way would be for the court to give some recognition to the public law nature of the regulatory rules by allowing them to affect the content of common law and equitable obligations. We have seen how market and trade practices may shape the content of contractual duties (including the reasonableness of exemption clauses) and duties of disclosure.[170] This third "hybrid model" accordingly ensures that "general" principles of private law ultimately prevail unless the statute expressly or by necessary implication authorises their modification or abrogation. However, in determining the content of those "general principles" the court should give effect to valid and reasonable regulatory rules and practices. This model draws on the process of implication of a term by custom but here it is the public law validity of a rule that requires the court to give effect to it if reasonable, not its notoriety or the intentions of the parties.

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[166] *Lee (David) & Co (Lincoln) Ltd.* v. *Coward Chance* [1991] 1 Ch. 259, 266 *per* Browne-Wilkinson V.-C., although there was in fact no incompatibility between the rules and the general law in that case and the statutory basis of the Law Society's rulemaking power was not considered; see further paras. 4.5.9 and 5.3.33, above.

[167] Arguably the rules of non-profit making non-governmental public bodies should get the benefit of the more "benevolent" approach set out in the context of a local authority in *Kruse* v. *Johnson* [1898] 2 Q.B. 91 where their authority is accompanied by similar "checks and balances".

[168] In *Associated Provincial Picture Houses Ltd.* v. *Wednesbury Corporation* [1948] 1 K.B. 223 Lord Greene M.R. stated the basic principles of judicial review of discretionary powers; i.e. propriety of purpose, relevance of considerations taken into account and the residual ground of "unreasonableness" or "irrationality", on which, in the context of rulemaking powers, see *Kruse* v. *Johnson* [1898] 2 Q.B. 91; *Re Toohey, ex p. Northern Land Council* (1981) 38 A.L.R. 439.

[169] *Kruse* v. *Johnson* [1898] 2 Q.B. 91 (bylaws of public non-profit making bodies to be benevolently interpreted); *Mixnam's Properties Ltd.* v. *Chertsey U.D.C.* [1965] A.C. 735, 755 (per Viscount Radcliffe, albeit in a minority).

[170] See Section 3.2 and para. 3.4.7-3.4.10, above.

5.4.8 (a) The Private Law Model: Under this "special" regulatory law is presumed to be subject to "general" principles of private law unless the common law principles are necessarily overridden by the statute. Thus, in the context of the FSA, there would be no authority to make rules altering such rights and obligations save where it is given expressly or by necessary implication. On this approach the contrast between sections 81 and 55 of the FSA on the one hand and section 48 on the other is significant. There is no clear authority given under the rulemaking powers of section 48 to alter common law and equitable rights and obligations and to imply such authority might be thought to give no effect to the presumption. The authority of third tier SRO rules is, as we have seen, even less apparent.

5.4.9 This approach has two consequences. First, it might be said that the fact that sections 48(2)(g) and (h) contemplate rules restricting disclosure to third parties, including customers, can at most authorise a rule which operates solely in the regulatory context. In respect of section 48(2)(g), it might be said that all that is authorised are rules that can be superimposed upon the common law.[171] In respect of section 48(2)(h) it is true that there could be difficulties for those subject to regulation since they might be put under conflicting obligations if the regulator requires them to withhold information which common law or equity requires them to disclose. It might, however, be said that such difficulties would be a consequence of the way the regulator chose to exercise its rulemaking power and this might well incline a court to give a restrictive interpretation to the regulatory rule either as a matter of construction or as a matter of vires.[172] A more fundamental objection to such a conclusion in the case of section 48(2)(h) is the argument noted above[173] that the use of the word "enabling" impliedly gives authority to modify common law and equitable duties of disclosure since a person cannot be "enabled" to withhold information if he is in any event free to do so.

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[171] Cf. the reasoning used in *E.T.U.* v. *Tarlo* [1964] Ch. 720, 731 in the context of the Solicitors Act 1957).

5.4.10 The second consequence of this approach is that the statutory scheme of regulation with its powers of investigation and enforcement, the statutory compensatory remedy, provisions for injunctive and restitutionary relief and complaints procedures would be purely an additional level of protection for customers. It would not be regarded as a substitute for the protection afford by the rules of the law of agency and confidence. It is of interest to note that most of the respondents to our Issues Questionnaire stated that compliance with regulatory rules did not constitute compliance with their common law and equitable duties[174] and, as already noted, the White Paper which preceded the enactment of the FSA stated that "whenever an investment business acts as *agent* for a client, the general rules of agency and the consequent fiduciary duties apply to the business".[175]

5.4.11 The case for the private law model is, firstly, it is based on the dominant approach to statutory interpretation and preserves the rights investors would have had in the absence of statutory intervention. Secondly, given the statutory policy in favour of self regulation and the composition of the SROs, it reflects the fact that a decision was taken not to place this form of regulation wholly outside the private sphere.

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[172] On partial invalidity and severance see *D.P.P* v. *Hutchinson* [1990] 2 AC 783; *R.* v. *I.R.C., ex. p. Woolwich Equitable B.S.* [1990] 1 W.L.R. 1400.

[173] See para. 5.3.20, above.

[174] See Appendix 1. Approximately one third of respondents commented that it would be desirable for compliance with regulatory rules to constitute compliance with common law and equitable duties. They suggested that this would lead to greater certainty and allow for developments in market practice to be accommodated rapidly and flexibly. Investors would still be protected adequately by the regulatory regime.

[175] (1985), Cmnd. 9432, para. 7.6. See also para. 2.9 and Professor Gower's call that the rules embody basic principles of law: *Review of Investor Protection* (1984), Cmnd. 9125, para. 6.30.

5.4.12 The private law model, however, has three disadvantages. First, in order for it to operate harmoniously in tandem with regulatory law, it is necessary for the latter to replicate common law rules or, alternatively, it posits two independent systems of law; one operating in the regulatory context, the other in the ordinary courts. Both alternatives are very confusing and complicated not least because of the difficulty of accurately stating the equitable rules in a legislative form. Secondly, this approach may imperil important aspects of the regulated system, for instance by concluding that the impossibility of disclosure that would satisfy common law requirements means that the authorised broker/dealer is always vulnerable to claims that the transaction be set aside, that he account for his "turn" if he deals as a principal, or that he account for his commission if he has not made full disclosure, or he has effected an agency-cross. Similarly, this might lead to the conclusion that fully operational Chinese walls are ineffective to prevent the attribution of information within a single corporate entity. Thirdly, this model does not give any recognition to the expertise of the bodies to which Parliament has entrusted the regulation of financial services.

5.4.13 (b) The Public Law Model: Under this, the process of interpreting the scope of the rulemaking powers would not start with presumptions about the common law's survival. On this approach the absence of an express power to alter non-statutory private law rights in the rulemaking powers is not important in determining the scope of the rulemaking powers. What is important is the nature and scope of the statutory scheme. The more specific and detailed this is, the less room there is for presuming that it is incomplete. In some, but by no means all, circumstances it might be *Wednesbury* unreasonable[176] or incompatible with statutory purposes for a rule to alter common law rights. But such a limitation should be deduced from the words of the statute itself and by a fair deduction from those words rather than by applying a presumption.[177] The Court would take account of the entire regulatory framework and give due regard to the expertise of the regulatory body and the fact that the court's role is a limited reviewing or supervisory one. Invalidity would be the result of non-conformity to the statutory purposes and not of non-conformity to the common law. This public law model takes account of the approach of the courts to the interpretation of statutes which remit authority to a regulatory body. Where appropriate, the regulatory body may be given an appreciable margin by the court recognising regulatory expertise, perhaps characterising the meaning of statutory words as involving questions of "fact and degree" rather than questions of law[178] and characterising the relationship between the courts and the regulators as a partnership.[179]

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[176] See para. 5.4.6, above.

[177] *Mixnam's Properties Ltd.* v. *Chertsey U.D.C.* [1965] A.C. 735, 755 per Viscount Radcliffe, albeit in a minority, see n. 164 and 169, above. See also *Collman* v. *Mills* [1897] 1 Q.B. 398 where, although the court stated that a bylaw must not be repugnant to the common law unless within the express power given by the statute, it found such express authority in a broad rulemaking power to regulate the conduct of any business.

5.4.14 The approach of the House of Lords in *Swain* v. *Law Society,*[180] discussed above, suggests that a statutory rulemaking power can impliedly empower rules which authorise what would otherwise constitute a breach of fiduciary duty and that, in the absence of a ground to review judicially the exercise of the power, there will be no private law remedy.[181] As already noted,[182] in *Swain's* case the exercise of public law rulemaking power was held to have two consequences. First, a non-party to a contract of insurance was accorded enforceable rights and duties under the contract. Secondly, the Law Society, which acted as an intermediary, was not subjected to a duty to account for commission received from the brokers. This was because it was acting in a public capacity:

> "[W]hat they do in that capacity is governed by public law; and although the legal consequences of doing it may result in creating rights enforceable in private law, those rights are not necessarily the same as those that would flow in private law

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[178] *Puhlhofer* v. *Hillingdon L.B.C.* [1986] A.C. 484, 517-518.

[179] *R.* v. *Panel on Take-Overs and Mergers, ex p. Datafin Plc* [1987] Q.B. 815, 842. See also *R.* v. *M.M.C., ex p. Argyll Group Plc.* [1986] 1 W.L.R. 763; *R.* v. *M.M.C., ex p. Elders IXL Ltd.* [1987] 1 W.L.R. 1221.

[180] [1983] 1 A.C. 598, see paras. 5.3.34-5.3.35, above.

[181] *Ibid.*, 618 (per Lord Brightman).

[182] Para. 5.3.34, above.

> from doing a similar act otherwise than in the exercise of statutory powers."[183]

The scope of this decision is not entirely clear. However, in the case of financial services, the case for a similar approach and the adoption of this model is set out in the following paragraphs.

5.4.15 Parliament has created "an elaborate new structure"[184] to achieve the legislative aims of facilitating efficiency, competitiveness, flexibility and above all investor protection.[185] The FSA contains rulemaking powers concerning the relationship between authorised persons and their customers.[186] The direct and indirect statutory controls over the rules of the SIB and SROs and, in particular, the role of the Secretary of State show that it was contemplated that regulatory rules which passed muster would adequately protect investors. Under the statute investors benefit from active regulation and monitoring of investment business including the exercise of investigative and enforcement powers. The aim is to give them the benefit of prevention as well as of cure - which is what common law and equitable remedies give. They are also given a new statutory action for damages for breaches of regulatory rules.[187]

5.4.16 The elaboration and detail of the scheme and the variety of techniques available under it to protect investors suggests that it would be wrong to assume that the statute and its rulemaking powers should be interpreted as being in the shadow of the common law. Such an interpretation would be likely to frustrate one of the principles underlying the new system: that "[t]he law should provide a clearly understood set of general principles and rules".[188] As mentioned above, the White Paper, while accepting that the general rules of agency and consequent duties would apply to an investment business acting as an agent, contemplated that concerns that, at common law, are addressed by general rules of agency and fiduciary duties would be addressed by regulatory rules providing for "best execution" and the subordination of a business' interests to those of its customers.[189] One way of addressing the tension between these two statements is to interpret the statutory rulemaking powers as requiring that the common law and equitable rules be replicated by the regulatory rules.[190] But, as has been said, this is a recipe for uncertainty and means that the discretion given to the regulatory authorities and the Secretary of State in respect of the adequacy of investor protection is substantially removed.

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[183] [1983] 1 A.C. 598, 608 (per Lord Diplock).

[184] *R.* v. *Secretary of State, ex p. R* [1989] 1 W.L.R. 372, 377 (Mustill L.J.).

[185] *Financial Services in the United Kingdom: A New Framework for Investor Protection* (1985), Cmnd. 9432, Ch. 3.

[186] See also the disclosure provisions of FSA, Part VIII (ss. 179-182).

[187] FSA, s.62. The restriction of this remedy to "private" investors in 1991 cannot affect the construction of the 1986 Act. In any case the argument for this approach is based on the entirety of the regulatory system; the statutory damages action is simply one component of this and the other important components, such as FSA, s. 61, remain generally applicable.

5.4.17 Another possibility is to interpret the statutory rulemaking powers as enabling only the enhancement of investor protection. Such an approach is, however, virtually unworkable. While a particular regulatory rule might provide less than a particular equitable rule (say by authorising a lower level of disclosure, or by not attributing knowledge where the common law would), the regulatory scheme as a whole might provide more. Unless one compared the entire common law and equitable package of protection with the entire regulatory package, the exercise would be somewhat artificial. Furthermore, under the FSA, the entirety of the regulatory scheme including all controls to which an organisation's members are subject is to be taken into account in determining whether there is adequate protection for investors.[191]

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[188] *Financial Services in the United Kingdom: A New Framework for Investor Protection* (1985), Cmnd. 9432, para. 3.2.

[189] *Ibid.*, para. 7.6.

[190] For a similar approach, albeit in different contexts, see *Mixnam's Properties Ltd.* v. *Chertsey U.D.C.* [1965] A.C. 735; *Pyx Granite Co. Ltd.* v. *Ministry of Housing and Local Government* [1958] 1 Q.B. 554 (reversed on another point, [1960] AC 260); *National Assistance Board* v. *Wilkinson* [1952] 2 Q.B. 648; *Minet* v. *Leman* (1855) 20 Beav. 269.

[191] FSA, s. 128A; Sch. 2, para. 2 (as amended by Companies Act 1989).

5.4.18 Apart from the inconclusiveness of the absence of an express power to make rules altering non-statutory private rights for the reasons set out here, the arguments in paragraphs 5.3.20-5.3.22, above provide positive reasons for an interpretation which permits such alteration in the case of the powers under section 48.

5.4.19 The advantage of the public law model is that its recognition of regulatory expertise facilitates the achievement of the statutory purposes and the development of one clearly understood set of general principles and rules and thus promotes certainty. The regulators are not left with an unfettered hand because they are subject to the supervision of the Secretary of State[192] and because the courts retain power under their supervisory jurisdiction to hold that a rule is invalid because of non-conformity to the statutory scheme, a central part of which is to ensure adequate investor protection.

5.4.20 There are, however, difficulties in applying this model. As we have seen, the source of SROs' rulemaking power lies in their objects and their recognition by the SIB rather than in any direct legislative grant. While, therefore, there may be a strong case for using this model for the SIB's rules, it may be difficult to use it for the SROs' rules which do not derive from a statutory source. We understand the SIB believes that it is desirable to treat its rules and the SROs' rules in as integrated a way as possible. If so, the use of this model for the SIB rules may, in fact, act as a barrier to such integrated treatment.

5.4.21 The public law model does, moreover, have several disadvantages. First, regulators might stop framing their rules in the shadow of and by reference to the principles of agency and fiduciary law which many regard as having a proven track record as effective protection for those who deal with an intermediary or fiduciary and who are prepared to litigate.[193]

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[192] See para. 2.5.6, above.

[193] In the light of the Maxwell pensions affair, there may be greater willingness to accept that a proactive regulatory system which does not rely on private enforcement has advantages. See para. 6.8, below.

Although the regulatory rules are subject to judicial review and to the control of the SIB (in the case of SROs) and the DTI[194] this might not be adequate in view of the of the differences between public law and private law rights.[195] The scope of judicial review of delegated legislation may well be narrower than in respect of other administrative action.[196] Even where a ground for review has been established the discretion to refuse a remedy might be exercised more readily in respect of rules.[197] Thirdly, the non-judicial controls on delegated legislation are limited even where there is a Parliamentary safeguard.[198] Where, as in this context, there are no Parliamentary safeguards since rules are not subject to the affirmative or negative procedure and do not have to be laid before Parliament,[199] the dangers are greater, particularly in a system that is in part self-regulatory as in the case of financial services.

5.4.22 Secondly, the public law model may lead to differences between the position of different authorised persons which it is not easy to justify. For example, it appears that the Core Rules do not apply to RPBs.[200] If, for instance, as we believe may be the case, the rulemaking power in section 48(2)(h) empowers the SIB to modify the general law by a rule such as Core Rule 36, those authorised by membership of a RPB will be subject to the common law rules on attribution of knowledge within a single entity whereas those directly authorised by the SIB or by membership of a SRO will not. They may thus be in a disadvantageous position in respect of the same kind of business although, as the rules do not apply to them, they would not be subject to the statutory damages remedy under section 62 for breach of the rules. Again, if there is power to modify the general law, an imbalance between private investors and others who do not have the protection of the statutory damages remedy under section 62 may be created.[201] Although the force of the public law model comes from a comparison of the entirety of the regulatory system and not one isolated aspect of it, this consideration has been seen as important.

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[194] See FSA, s.115 (resumption of delegated functions).

[195] *Bourgoin SA* v. *Minister of Agriculture, Fisheries and Foods* [1986] 1 QB 716, 761.

[196] See in relation to unreasonableness, wrong purposes and relevant considerations; *Kruse* v. *Johnson* [1898] 2 Q.B. 91; *City of Edinburgh D.C.* v. *Secretary of State for Scotland* 1985 S.L.T. 551. See also *McEldowney* v. *Forde* [1971] A.C. 632. Cf. *Re Toohey, ex p. Northern Land Council* (1981) 38 A.L.R. 439 (High Court of Australia).

[197] *R.* v. *Secretary of State for Social Services, ex p. Association of Metropolitan Authorities* [1986] 1 W.L.R. 1.

[198] Beatson, "Legislative Control of Administrative Rulemaking: Lessons from the British Experience", (1979) 12 Cornell I.L.J. 199; Hayhurst and Wallington, "The Parliamentary Scrutiny of Delegated Legislation", [1988] P.L. 547.

[199] For another example of statutory codes not subject to parliamentary procedure, see those made under the Health and Safety at Work Act 1974, ss. 16-17.

[200] FSA, s. 63A inserted by Companies Act 1989, s. 194. Note, however, that compliance with the Core Rules will prevent there being a contravention of section 47 (criminal liability for misleading statements and practices).

5.4.23 (c) The "Hybrid" model: This model draws on the process of implication of a term by custom. We have seen that a term will be implied where it is notorious, certain and reasonable, and is recognised in the market as creating legal rights, and that regulatory practices have been important in establishing customs.[202] On this approach, a regulatory rule would be evidence or guidance as to the expectations of the parties and of market usage. Despite the undoubted similarities, this approach differs from the process in establishing a custom since here it is the public law validity of the particular rule that requires a court to give effect to it if reasonable, not its notoriety or the intentions of the parties. It is different from the public law model because it presupposes separate spheres of operation for regulatory rules and "ordinary" law, and because "reasonableness" is not restricted to *Wednesbury* reasonableness[203].

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[201] See paras. 2.5.4 and 5.4.15, above. However, note that this consideration cannot affect the determination of the scope of the rulemaking powers under the FSA 1986 since the distinction was introduced by the Companies Act 1989, s. 193.

[202] See section 3.2, above. See also *General Reinsurance* v. *Forsakringsaktiebolaget Fennia Patria* [1983] Q.B. 856 and 12 *Halsbury's Laws of England* (4th ed., 1975), para. 450.

[203] See para. 5.4.6, above.

5.4.24 The court might simply ignore the regulatory rule and has done so in the case of a regulatory body that operates in the private law sphere.[204] However, where one is dealing with non-statutory but public law regulation, as in the case of the Take-Over Panel or recognised SROs, although this remains a possibility, it is unlikely.[205] Thus, in a decision of the High Court of New Zealand dealing with the operation of Chinese walls in a solicitor's practice, [206] it was said that "the ethical standards set by [a] professional organisation do not measure a practitioner's fiduciary duty in equity to his customer but professional codes of practice must have some relevance to the latter, as indicating the degree to which, in changing circumstances, the legal profession has recognised the desirability of its members accepting particular obligations". There are a number of English examples of the use of regulatory rules to guide the court in determining whether an obligation under the general law exists or has been broken.

5.4.25 First, non-compliance with the rules may assist a court in determining that a state of affairs exists or that conduct falls below the required standard. For instance, the fact that company directors have ignored the Take-Over Panel's Code may make it "just and equitable" that a company be wound up[207] or indicate that there has been "unfairness" in the conduct of the company's affairs.[208] Again, the SIB "suitability" of investment rule may have the effect of imposing a duty on a broker to warn his customer against unsuitable investments whereas hitherto there was no such duty.[209]

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[204] *Warren* v. *Mendy* [1989] 1 W.L.R. 853, 871 ("It is of course no answer to a claim in constructive trust to say that the [British Board of Boxing Control's] regulations permit a manager to act also as a promoter".)

[205] *North and South Trust Co.* v. *Berkeley* [1971] 1 W.L.R. 470; where the practice of Lloyd's brokers in acting for both the assured and the underwriter was not validated is not inconsistent with the text because (a) the practice was not sanctified by a Lloyd's bylaw and, (b) the practice was considered unreasonable.

[206] *Mid-Northern Fertilisers Ltd.* v. *Connell Lamb Gerrard & Co.* (Auckland) unreported 18 September 1986 (Thorp. J.).

[207] *Re St. Piran Ltd.* [1981] 1 W.L.R. 1300.

[208] *Re a Company* [1986] B.C.L.C. 382 (Companies Act 1985, section 459). See also, *Re Chez Nico (Restaurants) Ltd.* [1991] B.C.C. 736, 751. See generally *Weinberg and Blank on Take-Overs and Mergers* (5th ed., 1989).

5.4.26 Secondly, the court, in certain circumstances, takes account of the public interest in determining whether there is liability for breach of a duty of confidentiality[210] and non-compliance with regulatory rules may be a ground upon which the Court will refuse to enforce a stipulation of confidence. In *Dunford & Elliot Ltd* v. *Johnson & Firth Brown Ltd.*[211] the court declined to enforce such a stipulation which infringed the Take-Over Code's provisions concerning equality of information. The information had been given in confidence to certain institutional shareholders to induce them to underwrite a rights issue. It is possible that a similar approach will be taken whenever the matter involves the exercise of equitable discretion.

5.4.27 Thirdly, and conversely, compliance with regulatory rules or the regulator's directions even where these have no public law component may facilitate a finding that there has not been "unreasonable" or "unfair" conduct.[212] A further, although untested, example is the payment of £85 million by Guinness to the shareholders in Distillers following a direction of the Take Over Panel without first seeking the consent of its shareholders. Unless the ruling of the Panel[213] made it reasonable for Guiness to make the payment, the propriety of the payment might have been open to challenge.

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[209] *Stafford* v. *Conti Commodity Services Ltd.* [1981] 1 All ER 691; Rider, Abrams & Ferran, *Guide to the FSA* (2nd ed., 1989), para. 608. See also, SIB Retail Regulation Review, *Report of a Study by Sir Kenneth Clucas on a new SRO for the Retail Sector* (March 1992), para. 5.38.

[210] See Gurry, *Breach of Confidence* (1984), ch. 15.

[211] [1977] 1 Lloyd's Rep. 505. See also *Crabtree* v. *Hinchcliffe* [1972] A.C. 707, 730.

[212] See *Lloyd Cheyham & Co. Ltd.* v. *Littlejohn & Co.* [1987] B.C.L.C. 303, 313; *Dawson International Plc.* v. *Coats Paton* [1989] B.C.L.C. 233 aff'd [1990] B.C.L.C. 560 on the relevance of guidance issued by Consultative Committee of Accountancy Bodies to auditor's liability. See generally the Opinions of L. Hoffmann QC, Mary Arden and J.A.D. Hope (as they then were) on the role of Statements of Standard Accounting Practice; Palmer's *Company Law* (24th ed., 1987), at F-900-921 (Release 31:1-vii-88); McGee, "The True and Fair View Debate: A Study in the Legal Regulation of Accounting", (1991) 54 M.L.R. 874. On ethical guidance and Insolvency Practitioners, see Anderson, "Insolvency Practitioners : Professional Independence and Conflicts of Interest" in *Current Issues in Insolvency Law* (ed. Clarke, 1991), at 1. See also *Re a Solicitor* (1987) 131 S.J. 1063.

5.4.28 Although many of these examples concern standards that are often seen as more flexible than the equitable "no conflict" rule, that rule is in fact formulated in terms of a "reasonable man looking at the relevant facts and circumstances of the particular case" thinking that "there was a real sensible possibility of conflict".[214]

5.4.29 An advantage of the hybrid system is that the courts retain control over the regulatory rules in the sense that they would only take account of a rule in the formulation of the common law or equitable duty if the rule was considered to be reasonable. Under this model the SIB rules and SRO rules can be treated in an integrated way and the common law can develop in an evolutionary way in the light of the experience gained in the regulatory system. A disadvantage of the hybrid model is that the application of a "reasonableness" test might be thought to entail unacceptable uncertainty. This is, however, a feature of the UCTA regime governing written standard terms of business to which commercial bodies are already subject.

5.5 Provisional Conclusions

5.5.1 In the context of financial services, it seems reasonably clear that the rulemaking powers under FSA, sections 81 and 55 authorise modification of the private law rights and duties of those dealing with authorised persons. We incline to the view that FSA section 48(2)(h) also authorises such modification, albeit within its limited sphere, but would welcome the views of consultees. Despite the argument[215] based on FSA, section 48(3), that if one of the particular powers in section 48(2) gives authority to modify duties owed to third parties under the general law, so does the general rulemaking power under section 48(1), the position under the other rulemaking powers in section 48 is by no means clear and the arguments seem balanced.

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[213] Take Over Panel Decision of 12 and 20 April 1989 affirmed by Appeal Committee on 13 June 1989.

[214] Para. 2.4.9(i), above.

5.5.2 Where, in relation to any given rulemaking power, it is not clear whether the statute expressly or impliedly authorises the modification of the private law rights and duties of those dealing with firms subject to regulation, the matter will depend on which of the above approaches applies to the particular rulemaking power. If, whichever approach is used, there is authority to modify private law rights, a rule which does so will be valid unless set aside in judicial review proceedings.

5.5.3 Where the regulatory body has no authority dispositively to modify private law rights, we incline to the view that a court should give some recognition to the public law nature of the rules and the expertise of the regulatory bodies to whom Parliament has entrusted the achievement of the statutory purposes, in the cases under consideration, customer protection, by taking account of them in ascertaining the precise content of the common law or equitable obligation where the rule is considered to be reasonable.[216] Although the matter is not free from uncertainty, we also believe that courts are likely to do this. It is for consideration whether the uncertainty should be resolved by a statutory provision requiring courts to take account of regulatory rules in determining whether a common law or equitable obligation has been broken. However, at this stage of our inquiry, where there is no authority to modify private law rights in a particular rulemaking power, we do not favour a court being obliged to hold that compliance with a regulatory rule automatically provides a defence (a "safe harbour") to an action for breach of a common law or equitable duty. In short, in the absence of authority in a particular rulemaking power to modify private law rights, we provisionally favour the "hybrid" approach. The views of consultees are invited on all of these matters.

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[215] Para. 5.3.22, above.

[216] In the non-*Wednesbury* sense. See para. 5.4.23, above.

PART VI

POLICY ISSUES FOR CONSIDERATION

6.1 We have identified the areas in which the fiduciary obligations of a firm to its customers and its duties under public law regulations either conflict or give rise to serious problems of mismatch and the range of probable and possible solutions to such problems under the existing law. The discussion has shown that there is at present great uncertainty in the law some of which stems from the fluidity of the fiduciary principle and the rights and obligations based on it. We now turn to consider whether the law is in need of reform and, if so, the options for reform. Given the uncertainties of the existing law, these options include some items which may in fact be achievable under the present law. As most of the problems that have arisen in practice and much of the discussion above have concerned the law of financial services, this part concentrates on that area. As we have already said, however, we believe that the general approach is in principle applicable to other areas of public law regulation. Similarly, we believe that the range of options for reform is also, in principle, applicable to other contexts. In this part we consider three matters. First, whether fiduciary law should take account of regulatory rules. If so, the second issue concerns the way it should do this. Thirdly, we consider whether reform is needed and, if so, the options for reform.

Should Fiduciary Law Take Account of Regulatory Rules?

6.2 The first issue is whether, in a situation in which there is a conflict between fiduciary obligations and regulatory rules, as a matter of policy the law should always regard the classic formulation of fiduciary obligation[1] as prevailing. The arguments for and against according primacy in all cases to the classical formulation of fiduciary obligation are set out below.

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[1] See section 2.4, above for an account of this.

(a) Fiduciary Obligations Should Not Take Account of Regulation

(i) Appropriateness of Fiduciary Law

6.3 The way courts have formulated and developed fiduciary law and the equitable obligations owed by fiduciaries represents the accrued wisdom of the legal system as to what is necessary to protect those to whom fiduciary obligations are owed. While it is true that the broad way the equitable obligations are formulated gives rise to some uncertainty, this is in itself an important component of the protection accorded. "Equitable principles have above all a distinctive ethical quality. They are of their nature of great width and elasticity .... [T]he establishment of fiduciary duties ... may arise in any circumstances at all, whether or not similar circumstances have come about previously ...".[2] Fiduciary duties operate in a prophylactic manner so as to ensure high standards of behaviour and to prevent technical evasion of the rules and obligations.

(ii) Regulation should not remove protection

6.4 Where a regulatory system, such as that under the FSA, is imposed it should be regarded as according additional protection to those to whom fiduciary obligations are owed. Indeed, this was the view of the purpose and objects of the FSA taken by a number of responsible bodies and commentators at the time of its enactment.[3] If the regulatory rules modify the fiduciary duties of firms subject to the FSA's regime, there will be differences between the position of different fiduciaries which it may not be easy to justify. We have seen,[4] that the rights of private investors, who have the protection of the statutory damages remedy under section 62 differ from the rights of others and that members of SROs may be treated differently from those authorised by virtue of membership of a RPB. There will be a similar imbalance between the rights of customers against fiduciaries not subject to the FSA regime and rights against those who are so subject.

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[2] Spry, *Equitable Remedies* (3rd ed., 1984), p.1.

[3] Para. 5.3.3, above.

(iii) Adequacy of market solutions

6.5 To the extent that there are conflicts between fiduciary obligations and regulatory rules it is considered by some that it is possible to avoid these by disclosure and consent in agreements with customers and by other market based arrangements such as independence policies, Chinese walls and refusal to deal.

(iv) Constitutional inappropriateness

6.6 It is constitutionally inappropriate to permit self-regulatory bodies largely only representative of the business or professional interests involved to alter common law or equitable obligations owed under the general law. The policy in favour of self regulation and the composition of the SROs reflects a decision not to place this form of regulation wholly outside the private sphere. It does not therefore follow from the fact that a statutory scheme was adopted that Parliament intended that there should be any derogation from private law rights. While SIB and the SROs are subject to the control of the Secretary of State for Trade and Industry, their rules are not subject to direct Parliamentary safeguards. They are not subject to disapproval by negative resolution of either House and they do not have to be laid before Parliament.

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[4] Para. 5.4.22, above.

(b) Fiduciary Obligations Should Take Account of Regulation

(i) Need to adapt fiduciary law

6.7 The decision, as a matter of legislative policy when considering whether the stock market was operating in an anti-competitive manner, to abolish fixed commissions, to remove the requirement of single capacity in stock-exchange transactions, and to permit the development of financial conglomerates created an entirely new situation.[5] The political and administrative decisions to this effect were given a statutory form by the enactment of the FSA.[6] Although firms could avoid conflicts by segregating functions and acting in a single capacity this is not, in the context of financial services, a realistic option given the political and administrative decisions and the enactment of the FSA. In the new situation the law should not require, as classic formulations of fiduciary obligations do, conduct which can only be achieved by a person or organisation acting in a single capacity. To this extent, the content of fiduciary obligations cannot be determined without having regard to the regulatory rules, although, as we shall see, this may be done in a number of different ways.

6.8 Furthermore, in assessing the impact of a regulatory system on customer protection, it is necessary to look at the overall picture. For instance, in the case of financial services, although by picking one isolated aspect it might be thought that the regulatory system was inferior to fiduciary law, taking the whole system into account this might not be the case. Thus, fiduciary law relies on private enforcement but, in the case of financial services, it is arguable that customers get the benefit of a pro-active system, compensation funds and, in the case of private investors, a statutory action for breach of the rules as well as many of the safeguards accorded by fiduciary law.[7] Where the regulatory system takes what appears to be a different approach from that taken by fiduciary law, it is legitimate to look at its own safeguards, for instance, in the case of financial services, the doctrine of best execution.

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[5] See Section 2.2 and para. 2.4.11, above.

[6] See paras. 5.4.15-5.4.16, above. See also Section 2.5(i) and paras. 5.3.24-5.3.25, above.

[7] This is important where fiduciary law does not adequately protect customers, a problem highlighted by the Maxwell pensions affair. See Second Report of the Social Security Committee, *The Operation of Occupational Pension Funds*, H.C. (1991-92) 61-II. See also para. 1.8, above.

(ii) Undesirability of conflicting obligations

6.9 To regard the regulatory system as an additional layer of protection which leaves fiduciary obligations untouched either requires regulatory rules to replicate common law rules or posits two independent systems of law; one operating in the regulatory context, the other in the ordinary courts. The first is very confusing and complicated, not least because of the difficulty of accurately stating the equitable rules in a legislative form. The second may subject people to conflicting duties and, even where it does not, in the context of financial services the existence of two independent systems would frustrate one of the principles underlying the system: that "[t]he law should provide a clearly understood set of general principles and rules".[8]

(iii) Inadequacy and uncertainty of market solutions

6.10 If measures of self-help such as contractual and structural arangements enabled customers and firms to deal with conflicts between fiduciary obligations and regulatory rules in a satisfactory way the case for reform would be weaker. However, for the reasons given in Parts III and IV of this paper[9] we consider that the techniques used by firms will not, in fact, be effective in significant categories of cases. Although, as a general rule, the principle of informed consent is a good one, in some situations it will be impossible or impractical to obtain sufficiently informed consent. It is not always possible to disclose in advance, for example, that there will be an agency-cross or that a broker-dealer will, in a particular transaction, act as principal.

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[8] *Financial Services in the United Kingdom: A New Framework For Investor Protection* (1985), Cmnd. 9432, para. 3.2.

[9] See the summaries at paras. 3.2.24-3.2.25, 3.3.39-3.3.42, 3.4.37-3.4.39, and 4.5.25, above.

6.11 We believe that generalised advance disclosure of the possibility of an altered capacity and potential conflicts of interest will be insufficient to avert breach in all cases unless it is established as such by a legally binding trade custom. We have seen that so far as consent to dual capacity is concerned, the weight of authority suggests that any such custom would be regarded by the courts as unreasonable. The cases were decided in a different commercial context in which customers may have been accustomed to those they dealt with acting in a single capacity and in which the custom was not legitimated by regulatory rules. It is also possible that courts would view contractual terms in a different way from alleged customs. However, the combination of contra proferentem rules of construction and the fact that disclosure of the precise nature and extent of a conflict cannot be made at the commencement of a relationship suggest that contractual solutions will not be effective. Even if a clause works initially it will not deal with later changes in the nature of the relationship such as where an execution-only client later takes, perhaps on an informal basis, advice from a firm.

6.12 As far as structural mechanisms are concerned, at bottom the Chinese wall will not work as a matter of private law. There is evidence that people do "cross" the wall but, even where it remains intact, the law on the attribution of knowledge within a single organisation means that it is unlikely to be legally effective. If the approach of the majority of the Court of Appeal in *Re a Firm of Solicitors*[10] prevails, Chinese walls may not even work between closely connected parts of a group of companies. This is because of the Court's view that despite proposals for the erection of a "Chinese wall", any reasonable person with knowledge of the facts would consider that some confidential information might permeate the wall and that save in a very special case an impregnable wall could never be created. It was the court's view that information has a tendency to seep and that the law should recognise this.

6.13 Reliance cannot, in any event, be placed on the different forms of self-help in view of the great uncertainty about all these matters. It is clear that sharply divergent views are taken by lawyers and other professionals on the issues we have considered. Some, relying on trade practice and the general effect of "big bang", consider that generalised advance consent and best execution rules will suffice to protect a firm from liability for breach of fiduciary obligations. Others, relying on the classic formulation of the fiduciary obligation and the requirements for sufficient disclosure, consider that there will be no protection.

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[10] [1992] 1 All E.R. 353. See para. 4.5.9(iii), above.

(iv) The public law aspects

6.14 The decision to use a particular form of public law regulation was a legislative one. The decision in the case of financial services to use the mix of regulatory bodies was taken by Parliament. In fact there are historical precedents for regulatory power being given to "private" boards and bodies.[11] Moreover, in the context of financial services, there is little functional difference, whatever was said at the time of the enactment of the FSA, between the SIB and a central regulatory body such as the United States's SEC or the British Office of Fair Trading. It is the public law nature of the system which should enable and justify some modification of common law and equitable duties.

6.15 Public law approaches may furnish the tools for resolving conflicts by recognising that public law regulation can affect common law or equitable duties either directly, where there is statutory authority to modify private law rights, or indirectly in the sense that the court will take account of regulations in deciding the precise content of the common law or equitable duty in a particular context. However, the indirect approach has not been considered by the courts in this context and there is accordingly uncertainty as to whether courts will utilise it and, if they do, in what way.

6.16 In our view the classic formulation of fiduciary obligations needs to take account of the way modern commercial organisations are organised and regulated. However, exactly how to do this and in what way raise difficult questions upon which we invite the views of all interested parties. We believe the aims of the law must be: the adequate protection of those to whom fiduciary obligations are owed, the customers and in particular private customers; and the facilitation of the efficient functioning of the market in which there is reasonable certainty as to customers' rights and practitioners' duties.[12] If it is considered that fiduciary law should not take account of regulatory rules, the second issue, considered below, does not arise. There may, nevertheless be a case for reform. The third issue, the options for possible reforms, is considered at paragraphs 6.22-6.29, below.

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[11] See Craig, *Administrative Law* (2nd ed., 1989), at 34-46, 71-75.

The Role of the Regulatory Structures and Rules

6.17 We believe that public law approaches may furnish the tools for resolving conflicts by recognising that public law regulations can affect common law or equitable rights either directly where statute gives authority to modify them, or indirectly in the sense that the court will take account of regulations in ascertaining the precise content of the common law or equitable duty. However, there is uncertainty as to the extent to which courts will interpret particular rulemaking powers as authorising modification of common law or equitable rights, and whether, if they do not, account can nevertheless be taken of the regulatory rules.

6.18 Where there is no authority in the statute to alter the rules dispositively, if fiduciary law is to take account of regulatory structures and rules, we have seen that there are broadly four ways in which this could be done. The first is what has been termed the "safe-harbour" approach whereby compliance with a regulatory rule which permitted that which was prohibited by fiduciary law would constitute a defence to any action for breach of fiduciary duty. This is, in effect, the position where the statute authorises the modification of private law rights as in the case of unit trusts.[13] We do not consider that this approach should be generalised. Apart from the constitutional considerations of allowing modification of common law and equity without Parliamentary safeguards, at present rulemaking by regulatory bodies must take account of fiduciary obligations wherever possible. This desirable safeguard which operates as an internal check on the process of rulemaking by regulatory bodies would be removed by the general adoption of this approach.

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[12] See para. 1.4, above.

[13] See para. 5.3.4, above and FSA, s. 81.

6.19 A second approach is to say that each body of law has its own separate sphere of operation. On this approach regulations would be irrelevant to the determination of whether there has been a breach of fiduciary obligation and fiduciary obligations would be irrelevant to the determination of whether there had been a breach of regulatory duties. We do not favour this for the reasons given in Part V,[14] i.e. it would lead to great complication and uncertainty as well as placing fiduciaries in the position where, in certain cases, if they are to comply with their fiduciary obligation they will be in breach of their regulatory duty and vice versa.

6.20 A third alternative is to interpret rulemaking powers as authorising only the replication of common law and equitable duties except where this is, as in the case of unit trusts, expressly stated not to be the case in the enabling statute. For the reasons given above,[15] in particular the changed market structure and the alternative safeguards of the regulatory system, we do not favour this approach. It would also lead to undesirable uncertainty as to customers rights and firms duties. Before making any rules, the regulatory body would have to decide exactly what is required by fiduciary law. There would, however, be great difficulty in deciding this and making a definitive statement of the requirement of fiduciary law because of the broad and general way in which fiduciary obligations are formulated.

6.21 The fourth approach, which we provisionally favour subject to the views of consultees, and which may indeed already be the law, is that regulatory rules should be taken into account by courts in determining the content of the relevant fiduciary obligations. This does not represent an abdication of control by the courts in favour of the regulators but an acceptance that the regulators' views in an area of public law remitted to them by the legislature are entitled to some weight. In Part V we saw that there are two ways of achieving this. We termed these the "public law" and "hybrid" approaches. For the reasons given,[16] in cases in which there is no statutory authority dispositively to modify private rights at present we favour the hybrid approach, although again we invite the views of consultees on this matter. The effect of the hybrid approach is that a court would take into account a reasonable regulatory rule[17] in determining the content of the fiduciary obligation. An objection to this approach might be that the notion of "reasonableness" still leaves uncertainty in the system. While this is true, the uncertainty is of a kind that has to be faced by firms in the operation of UCTA and the criteria used in determining whether a duty of care giving rise to a liability in tort is owed. In any event, there would be less uncertainty than there is at present.

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[14] See paras. 5.4.12 and 5.4.17, above.

[15] See para. 5.4.12, above.

Options for Reform

6.22 Whatever views there are about the desirable relation between fiduciary obligations and regulatory rules, the present position is regarded by many, including the Legal Risk Review Committee, as giving rise to uncertainty. Although some are content to accept this state of affairs pending a suitable case coming to court, we do not believe that this is the appropriate way to proceed given the wide-ranging nature of the problem. The accidents of litigation will mean that many issues will not fall for decision in one case. We believe that the present uncertainty and the sharply divergent views of the present state of the law are undesirable. We seek the views of all interested parties as to whether the current position involves unacceptable uncertainty. If it is considered that the present uncertainty should be resolved by a legislative measure, there are a number of options.

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[16] See paras. 5.4.23-5.4.29, above.

[17] This is not restricted to reasonableness in the *Wednesbury* sense, see para. 5.4.23, above.

6.23 The first is to codify fiduciary duties. We believe this is impractical. A code of fiduciary obligations would have to set out all the relevant obligations in all the relevant professional and business relationships. This has never been done and it would first be necessary to resolve many undecided questions of law. The DTI's attempt in 1973 to codify the duties of a single category of fiduciaries, company directors,[18] was unsuccessful. To codify the duties of a wide range of different types of fiduciary would be much more difficult. Moreover, we believe such an exercise, even if it were possible, would be undesirable given the nature and prophylactic function of fiduciary obligations. It would open the way for technical arguments which have properly been absent from this area of law.

6.24 Secondly, legislation could provide that generalised advance consent is always or in some circumstances effective. We are disinclined to favour this approach since in some cases it will be possible to make precise disclosure in advance and we see no reason why it should not be made in such cases. Where it is not possible to make such disclosure we believe that a general legitimation of clauses might not adequately distinguish between acceptable and unacceptable practices.

6.25 Thirdly, we have seen that some of the difficulties arise from the rigidity of the rules on attribution of knowledge within a corporation or partnership. If these could be changed so that the present irrebuttable presumption of knowledge between different parts of an organisation was replaced by a rebuttable presumption of knowledge, a firm which could demonstrate that there was in fact no knowledge in the relevant department might be able to defend a claim for breach of fiduciary duties.[19] Professor Gower believes that this might be the way forward.[20] Another leading commentator on fiduciary law, Professor Finn, has said that:

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[18] Companies Bill 1973, clause 52, set out in Appendix 2.

[19] Finn, "Conflicts of Interest and Professionals", in *Professional Responsibility*, (Legal Research Foundation, Auckland 1987), at 20, 34-6.

[20] Response to the Law Commission's Issues Questionnaire.

> "In the same way that we increasingly are being forced to acknowledge the artificiality of treating related companies as separate legal persons for all purposes, so also may it not be the case that it can be similarly artificial to treat the company - and especially the large and diversified company - as a single monolithic legal person for all purposes and in all circumstances. If it has, and can convincingly demonstrate that it has, segregated and insulated one of its service activities (in a way that is reasonable to render that service), could it not reasonably be said that its potential liabilities in and for the rendering of that service should prima facie be determined as if the department rendering that segregated service was a separate legal person?"[21]

6.26 An advantage of this approach is that it is general and would not be confined to financial services. Firms in any line of business would be treated alike whether or not they subsidiarise their departments. This approach would also avoid the distinctions which would have to be made between firms regulated by SROs and those regulated by RPBs if the effectiveness of Chinese walls is largely seen as a function of Core Rule 36. This is because, as has been pointed out in paragraph 5.4.22, the rulemaking powers under FSA, section 48 and the ability of the SIB to designate a Core Rule as applying to a recognised self-regulatory organisation does not extend to a RPB. However, this approach also has disadvantages. First, it might not be appropriate to remove the irrebuttable presumption in all contexts and for all purposes. The approach of the courts when considering Chinese walls in lawyers' practices suggests that a court would be reluctant to find any such presumption rebutted given the risk of adventitious and unintended disclosure and the need to ensure the appearance of probity both so as to maintain customer confidence and in the public interest. Secondly, this approach might provide firms with an incentive to organise their affairs to bring about ignorance[22] and this might, in itself, be undesirable in view of the reliance its customers would tend to place on it.

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[21] Finn, "Fiduciary Law and the Modern Commercial World", (Norton Rose Oxford Law Colloquium, 1991), at 18.

[22] See para. 2.3.5, above.

6.27 Fourthly, legislation could provide that a court must take account of a reasonable regulatory rule in determining the content of a fiduciary obligation and whether there has been a breach.[23] It will be recalled that "reasonableness" is not restricted to reasonableness in the *Wednesbury* sense.[24] We believe that it is at present possible for courts to do this and that in certain contexts it is likely that they will.[25] However, in view of the uncertainty, legislation may nevertheless be desirable. If this route is taken three further questions arise, upon which we invite the views of consultees:-

(i) Should the legislation give guidance as to what constitutes "reasonable",[26] or is no further guidance needed? For example, a court might be directed to consider whether the alternative protection offered by the regulatory system is in fact satisfactory in considering whether a regulatory rule is reasonable.

(ii) On whom should the burden of proof lie? We have reached no conclusion on this matter which is not entirely straightforward. If the role of the regulatory rule is analogous to a custom, it is arguable that it is for the person relying on it, here the firm, to establish its reasonableness. This would, however, create a situation in which all rules were in substance presumptively unreasonable which might be thought to involve unacceptable uncertainty. If, on the other hand, the court takes account of reasonable regulatory rules in determining the content of the particular fiduciary duty, the person alleging that there has been a breach of duty will have to show that account should not be taken of the rule in question. Furthermore, if one has regard to the fact that the regulatory rules under consideration operate in the public law sphere, it is arguable that, just as the applicant in judicial review proceedings has to establish the invalidity of the administrative act or rule, so the person alleging breach of duty should have to show that the rule was unreasonable.

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[23] A useful analogy may be the codes of practice made under the Health and Safety at Work Act 1974, s.16.

[24] See para. 5.4.23, above.

[25] See paras. 5.4.25-5.4.28, above.

[26] See, for example, UCTA Sch. 2.

(iii) Should the reasonableness of a rule be determined as at the time it was made, at the inception of the relationship between the parties or at the time the rule is relied upon? In the context of exclusion clauses, the Misrepresentation Act 1967 and UCTA provide that reasonableness is to be determined as at the time of contracting. However, this may not be appropriate in the present context because it might give firms and regulators an incentive not to update their customer agreements or rules to reflect current requirements. We incline to the view that the appropriate time for determining the reasonableness of a regulatory rule should be the time it is relied on, but we have reached no concluded view.

6.28 Fifthly, legislation could make provision for the exculpation of fiduciaries who, although they have breached their fiduciary duties, have acted reasonably. Section 61 of the Trustee Act 1925[27] provides a model. It states that "if it appears to the court that a trustee ... is or may be personally liable for any breach of trust ... but has acted honestly and reasonably, and ought fairly to be excused for the breach of trust and for omitting to obtain the directions of the court in the matter in which he committed such breach, then the court may relieve him either wholly or partly from personal liability for the same." This provision, which appears to operate satisfactorily, has not been narrowly construed,[28] although it would no doubt be more difficult for a paid professional trustee to establish that he "ought fairly to be excused.[29] There is a similar power to relieve an officer of a company or its auditor from liability for negligence, default, breach of duty or breach of trust under section 727 of the Companies Act 1985.[30] There is no reason to believe a similar provision in the context of financial services would not also work satisfactorily. We invite the views of consultees on the merits of such a provision and any practical difficulties that would have to be addressed if it is taken forward.

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[27] Largely re-enacting s. 3 of the Judicial Trustees Act 1896.

[28] *Re Allsop* [1914] 1 Ch. 1.

[29] See para. 3.3.12 (note 104), above.

[30] See *Farrar's Company Law* (3rd ed., 1991) (ed. Farrar, Furey and Hannigan), at 440-441.

6.29 Some of these options are not alternatives and it would be possible to pursue them together. Thus, it would be possible to legislate on general advanced disclosure, the rules governing attributable knowledge, the relevance of reasonable regulatory rules in determining the content of fiduciary obligation and, an exculpatory power in the court where a fiduciary has acted reasonably. We invite views as to whether we should pursue one of these and, if so, which one, or whether we should consider a cumulative strategy.

PART VII

PROVISIONAL CONCLUSIONS AND SUMMARY OF CONSULTATION ISSUES

7.1 We have considered:

(i) the extent to which the fiduciary obligations of firms and their duties under public law regulations either conflict or give rise to real problems of mismatch,

(ii) the extent to which principles of private law enable the parties to resolve any such conflicts by contractual or structural techniques, and

(iii) the consequences, if any, of the fact that the regulatory rules under consideration are the product of public law regulation.

We shall first set out our provisional conclusions on these matters and then summarise the law reform issues which arise and on which we seek the views of consultees.

7.2 Some of the problems identified by respondents to our Questionnaire arose from conflicts of interest which are not legitimised by regulatory rules. However, we believe that fiduciary obligations and duties under public law regulation do give rise to conflicts or problems of mismatch in a number of contexts, but primarily in the context of the provision of financial services. In that context the problems largely concern the disclosure of commission and other remuneration, relaxation of the "no-profit" rule and the operation of Chinese walls (paras. 1.9-1.13).

7.3 A number of contractual and structural self-help techniques are commonly used by firms to deal with these problems. The main contractual technique is the use of general advance disclosure and consent provisions in customer agreements. The main structural technique is the Chinese wall. Our overall provisional conclusion is that, although the position is not clear, short of declining to act or segregating functions and acting in a single capacity, unless a binding trade custom can be established, these techniques are unlikely to prove effective under private law principles to avoid liability for any but the simplest of the conflicts we have identified.

Contractual Techniques

7.4 The extent to which it is possible to modify or to exclude fiduciary duties by the terms of a contract or other instrument cannot be stated with precision. Where a fiduciary relationship existed between the parties prior to the time the contract was made it will be harder to exclude duties in the absence of full disclosure, possibly independent advice and the court being satisfied of the overall fairness of the contract (para. 3.3.4).

7.5 Where there is no fiduciary relationship in existence prior to the contract, the approach of the court will depend on the type of exclusion clause used and the extent to which the relationship is regarded as one of status rather than of contract. Where a duty defining clause is used, there is some doubt as to whether it will be treated as defining the terms of the relationship or whether the court will look to the core of the relationship and strike down the clause if it is repugnant to this, for example, if it purports to allow an agent-fiduciary to act as a principal. We incline to the view that a sufficiently clear clause will be treated as defining the terms of the relationship (paras. 3.3.8-3.3.12; 3.3.39).

7.6 Although in principle generalised advanced disclosure of the possibility of an altered capacity and potential conflicts of interest may be legitimated if recognised as a legally binding trade custom, the weight of authority suggests that any custom authorising a fiduciary to act in a position of conflict would be regarded by the courts as unreasonable except possibly if the court regarded the conflict as purely technical in the sense that there is no risk of prejudice to the beneficiary. The question of whether a practice authorising a fiduciary to act in a position of conflict which is sanctioned by a regulatory rule would qualify as a binding custom has not to our knowledge been considered by the courts (paras. 3.2.24-3.2.25).

7.7 With regard to disclosure and consent, where there is no question of a binding custom, as a general rule fiduciary duties may be modified or displaced if the beneficiary's consent is obtained after making full disclosure of all material facts. However, it is impossible to set out a precise formula for ascertaining what must be disclosed in any particular circumstances. In some situations it will be impossible to obtain sufficiently informed consent no matter how full the disclosure. Even if it is possible to know what must be disclosed, it will often be impossible or impractical to divulge the requisite information in advance of the breach of duty or at all. Where disclosure is made in advance, a conflict which was not predicted may subsequently arise leaving the firm open to liability. It is unlikely that the disclosure clauses in customer agreements can cover all eventualities in sufficient detail. There is also considerable doubt as to whether compliance with the disclosure requirements of the regulatory rules will satisfy general law requirements, for example where a broker takes soft commission or operates an independence policy (paras. 3.4.37-3.4.39).

7.8 There are thus uncertainties as to the extent to which a fiduciary can exclude liability for breach of fiduciary duties or modify duties by exclusion clauses or by disclosure. Quite apart from these uncertainties, an exclusion clause will not prevent the introduction of new fiduciary duties into a relationship as it evolves over time in a way which overrides the initial contractual arrangements (paras. 3.1.2, 3.3.22).

7.9 Our overall provisional view is therefore that neither exclusion clauses nor disclosure and consent are in fact an effective general means of modifying the normal incidents of a particular fiduciary relationship so as to avoid any conflicts between the fiduciary duties and duties imposed by the regulatory rules. We invite the views of consultees on these matters.

Structural Techniques

7.10 There appears to be general agreement among respondents to our Questionnaire that elimination of conflicts by an enforced separation of functions is neither feasible nor in many cases, including situations concerning financial services, desirable. In any case, even with separate legal entities, it would still be necessary to ensure that information was not improperly leaked from one legal entity within a group to another entity within that group or known by the fiduciary firm because of shared personnel, for example a person who is on a number of boards of directors within a group (paras. 4.2.1-4.2.2).

7.11 The regulatory rules recognise that in certain circumstances declining to act may be the most appropriate way of dealing with a conflict of interest. Although this is undoubtedly the case, we believe that, in the context of financial services, given the decision to adopt a market structure which involves multi-function conglomerates, this cannot be a general solution to the problem of conflict. Furthermore, it cannot deal with a conflict which is not apparent or known at the commencement of a relationship (paras. 4.3.1-4.3.5).

7.12 Although the principle of independence and independence policies have been used as a means of managing conflicts, particularly in share transactions, they do not eliminate conflict and, as such, cannot in our provisional view be safely relied on to modify fiduciary obligations (paras. 4.4.1-4.4.2).

7.13 The most favoured technique for dealing with many conflicts arising from the carrying on of financial business within a conglomerate is the use of Chinese walls. The purpose of a Chinese wall is to prevent the attribution of knowledge between the component parts of a firm where procedures for restricting information flows between those parts are in place to ensure that information which is confidential to one part is not improperly or inadvertently communicated to any other part. It is, however, unclear whether, as a matter of private law, the existence of an effective Chinese wall would be regarded as providing protection to a fiduciary in a conflict situation. The English decisions have concerned the use of Chinese walls by solicitors and, in this context, the courts have not seen the Chinese wall as providing satisfactory protection for the interests of clients (paras. 4.5.7-4.5.9, 4.5.25).

7.14 When a customer is aware of the existence of a Chinese wall and consents to a firm handling his affairs on the basis that the wall will staunch information flows within the firm, the consent and disclosure may in our provisional view result in the Chinese wall providing some protection to the firm (para 4.5.16). This, however, is subject to the limitations on the effectiveness of disclosure mentioned above and the effectiveness of the wall.

7.15 Where there has been no disclosure of the existence of a Chinese wall, or no consent by the customer, the position is less clear. A customer has every expectation that the firm advising him will use all the information in its possession to further his interests except possibly (but not necessarily) where disclosure of the information would be a criminal act. Where disclosure amounts to a breach of confidence to another customer it is arguable that the firm should not have put itself in the position where the duty that it owes to one customer cannot be discharged because of a duty owed to another customer. Where the problem is a conflict of interest, the position is even more uncertain. However, as a matter of private law, unless the customer consents to the conflict of interest it is difficult to see how the mere existence of the Chinese wall can protect a firm where it enters into a transaction in which it has a material interest which conflicts with that of its customer (paras. 4.5.17-4.5.18).

7.16 The difficulties of relying on Chinese walls as a structural method of dealing with conflicts between fiduciary obligations and regulatory rules are intensified when one takes into account the fact that, in certain circumstances, a member of the firm, for example an analyst, will temporarily "cross" the wall. Although there are undoubtedly practical difficulties, our preliminary view is that the practice of taking an analyst out of circulation until the confidential information he has learned by crossing the wall is no longer price sensitive does not give rise to such a serious risk of indirectly communicating the nature of the information to a shrewd customer that it could not for this reason be adopted. We also believe that other ways of handling the analyst who returns to his former position, in particular continuing his advice to that set out in a previously published document, are unlikely to afford an adviser a defence to an action for breach of the duty to disclose relevant information. We invite views as to how necessary wall crossing by analysts is considered to be (paras. 4.5.20-4.5.22, 4.5.25).

7.17 There are further difficulties that arise because of the existence of those in managerial positions who will overlook a Chinese wall in the sense that their "need to know" in order to discharge their duties will result in their obtaining information otherwise retained behind a Chinese wall. Where this gives rise to a conflict of duty, a firm may obtain whatever protection is provided by disclosure and consent but, as we have seen, there are limitations to the effectiveness of such disclosure and consent. Where the conflict thus created is a conflict of interests, the situation is more problematic and it is difficult to see how the Chinese wall can provide any protection. Although we have formed no views on the matter it is possible that the use of stop lists and watch lists will provide a solution (paras. 4.5.23-4.5.24).

The Impact of Public Law

7.18 Where an area of business or professional activity is subject to public law regulation, we provisionally believe that the classic formulation of fiduciary obligations needs to take account of the way modern commercial organisations are organised and regulated. We have stated that the aims of the law should be the adequate protection of customers, the facilitation of the efficient functioning of the market and clarity as to customers' rights and firms' duties (para. 1.4, 6.16).

7.19 Our primary reason for this provisional conclusion is that the decision to use a particular form of public law regulation and a particular regulatory body is a legislative one. The regulatory body is likely to have a certain expertise in the area remitted to it by Parliament and we believe it is in principle correct for the courts to accord some recognition to that expertise as they already do in a number of contexts (paras. 5.4.24-5.4.27, and 5.5.3). Although, care must be taken where the regulatory body is largely representative of only the "business" or "professional" interests involved, it is correct to consider whether public law approaches may furnish the tools for resolving conflicts between common law and equitable duties and regulatory rules.

7.20 We believe that FSA sections 55 and 81 authorise modification of the private law rights and duties of those dealing with authorised persons and we incline to the view that FSA section 48(2)(h) also authorises such modification, albeit within its limited sphere. We invite the views of consultees on these matters and on the question whether the general rulemaking power in FSA section 48(1) also authorises the modification of the private law rights and duties of those dealing with authorised persons (paras. 5.3.6-5.3.22, 5.5.1).

7.21 Where, in relation to any given rulemaking power there is no authority dispositively to modify private law rights, the matter will depend on which of the approaches we have considered applies to the particular rulemaking power. We do not, however, favour a court being obliged to hold that compliance with a regulatory rule should automatically provide a defence to an action for breach of a common law or equitable duty (para. 5.5.3, 6.18).

7.22 Subject to the views of consultees, where there is no authority for the direct modification of private law rights, we provisionally favour the approach which we have termed the "hybrid approach". Under this, which may already be the law, reasonable regulatory rules[1] would be taken into account by courts in determining the content of the relevant fiduciary obligations. The effect of this approach is that, where a court considers that a regulatory rule is reasonable, it would be taken into account in determining the content of the fiduciary obligation. Thus, non-compliance with a reasonable regulatory rule may tend to indicate that conduct falls below the required standard, while compliance with such a rule will tend to indicate that there has been no breach of duty (paras. 5.4.23-5.4.29, 6.21).

7.23 Furthermore, given the uncertainty as to the current position, even if the hybrid approach does represent the existing law, we incline to the view that the present uncertainty should be resolved by a legislative measure. We invite views as to whether legislation is necessary and how, if at all, account should be taken of public law regulations in determining whether there has been a breach of a common law or equitable duty.

7.24 If provision is to be made in legislation that a court should take account of reasonable regulatory rules in ascertaining the precise content of the relevant fiduciary obligations, the questions of whether there should be legislative guidelines, the burden of proof and the time at which reasonableness is determined arise. We invite the views of consultees on these matters (para. 6.27).

7.25 Apart from a general provision permitting the court to take account of reasonable rules made by public law regulatory bodies in determining the content of common law and equitable duties, there are a number of other legislative possibilities;

(i) the codification of fiduciary duties: we have provisionally concluded that such an exercise would be both very difficult and undesirable on policy grounds (para. 6.23);

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[1] This is not restricted to *Wednesbury* reasonableness. See para. 5.4.23, above.

(ii) legitimation of generalised advance consent: we are disinclined to favour this approach since in some cases it will be possible to make precise disclosure in advance and where this is not possible a general legitimation might not adequately distinguish acceptable and unacceptable practices (para. 6.24);

(iii) the rules on attribution of knowledge within a corporation or partnership (set out in paras. 2.3.1-2.3.11) could be changed so that the present irrebuttable presumption of knowledge between different parts of an organisation is replaced by a rebuttable presumption: we have not formed a provisional view on the desirability of this and would therefore particularly welcome the comments of consultees and their views on the advantages and disadvantages of this approach as set out in paragraphs 6.25-6.26 above; and

(iv) legislation could provide for the exculpation of fiduciaries who, although they have breached their fiduciary duties are considered by the court to have acted honestly and reasonably (para. 6.28).

7.26 These options should not necessarily be regarded as alternatives to each other or to a general provision permitting the court to take account of reasonable public law regulations in determining the content of common law and equitable duties since it would be possible to pursue them together. We invite views as to whether we should pursue one of these solutions and, if so, which one, or whether we should consider a cumulative strategy.

SUMMARY OF CONSULTATION ISSUES

The principal matters on which we invite the views of consultees are the following:-

(1) Can conflicts between fiduciary duties and what is permitted by the regulatory rules be completely avoided by the use of all or some, and if so which, of the

following methods of modifying the normal incidents of a particular fiduciary relationship:

(a) exclusion clauses,
(b) disclosure and consent, and
(c) Chinese walls?

Our provisional view is that, under private law, they cannot.

(2) A number of questions arise out of the practice of members of firms, for instance analysts, temporarily "crossing" a Chinese wall.[2]

(a) How necessary is it for members of firms to "cross" a Chinese wall?
(b) Does taking an analyst out of circulation until the confidential information he has learned by crossing the wall is no longer price sensitive give rise to a serious risk of indirectly communicating the nature of the information to a shrewd customer?

Our preliminary view is that, although there are undoubtedly practical difficulties in taking an analyst out of circulation, they are not so great that this method of proceeding could not for this reason alone be adopted. We believe that other ways of handling the analyst who returns to his former position, in particular confining his advice to that set out in a previously published document, are unlikely to afford an adviser a defence to an action for breach of the duty to disclose relevant information.

(3) A number of questions arise out of the fact that those in managerial positions and compliance officers "overlook" a Chinese wall in the sense that their "need

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[2] See paras. 4.5.20 - 4.5.22, above.

to know" in order to discharge their duties results in their obtaining information otherwise retained behind a Chinese wall.[3]

(a) Is it feasible to use stop lists and watch lists as a solution?

(b) Can the inadvertent signalling effect, which may result from placing a share on a stop list, be avoided in those situations in which firms use such lists?

(4) Should fiduciary law take account of rules made by regulatory bodies operating in the public law sphere? Our provisional view is that it should: either because there is statutory authority for rules to modify common law and equitable obligations (as we believe to be the case in respect of FSA, sections 55 and 81 and may be the case in respect of FSA, section 48(2)(h)); or because the court should take account of reasonable[4] regulatory rules in ascertaining the precise content of the common law or equitable duty.

(5) Should legislation provide that the courts must take account of reasonable regulatory rules in ascertaining the precise content of common law and equitable obligations? If so:

(a) should there be legislative guidance as to what constitutes "reasonableness",

(b) on whom should the burden of proof lie, and

(c) should "reasonableness" be determined at the time the rule was made, at the inception of the relationship between the parties, or at the time the rule is relied on?

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[3] See paras. 4.5.23-4.5.24, above.

[4] See para. 5.4.23, above.

(6) What other legislative possibilities should be considered, either as alternatives to that summarised in (5) above or as supplements to it? We have mentioned:

- (a) the codification of fiduciary duties,
- (b) legitimation of generalised advanced consents,
- (c) reform of the rules on attribution of knowledge within a corporation or partnership, and
- (d) exculpation of fiduciaries who the court considers have acted honestly and reasonably.

APPENDIX 1

ANALYSIS OF QUESTIONNAIRE RETURNS

Introduction

The Issues Questionnaire, together with an explanatory Introduction setting out the purpose of the exercise, was circulated by the Law Commission on 7th November 1990 and the Scottish Law Commission on 13th November 1990. Details of the main types of business and profession to whom it was sent and from whom responses were received are set out in paragraph 1.6, above. Many of the replies were marked "Confidential" so that the following analysis is not a complete picture. Moreover, some replies contained internal inconsistencies and not all of the questions were relevant to each respondent. However, this has not affected the aim of building up a general picture of the extent to which the relationship between the fiduciary duties owed by professionals and businesses which are subject to public law regulation and the duties imposed by statutory and regulatory rules is perceived to give rise to problems.

Q. 4.1 Do you believe that compliance with the regulatory rules to which a professional is subject constitutes compliance with fiduciary duties?

Most respondents do not believe that compliance with the regulatory rules to which fiduciaries are subject constitutes compliance with their fiduciary duties. Most neither gave reasons for their opinion, nor details of their perception of the impact of the rules on fiduciary duties. Those that did differed widely in their approach.

Q. 4.2 Do any categories of professionals, for instance advisers, brokers, intermediaries (both tied and independent), trustees (including corporate trustees) face particular problems? If so, what are they?

Q. 4.3 Do any categories of business, for instance banking, corporate finance, custodianship, fund management, insurance, legal services, market-making, stockbroking, give rise to particular problems?

Many of the problems identified do not arise from a mismatch or potential mismatch between the regulatory rules and fiduciary duties. Some arise from conflicts inherent in the activities of the particular profession or business and are prohibited by both the rules and the general law. The analysis of the answers to these questions therefore needs to be treated with a certain amount of caution. The majority of problems identified relate to the provision of financial services. The category of business most commonly cited as causing problems is that of trustees. However, the problems which they encounter are outside the scope of this paper.[1] Beyond this, brokers, fund managers, intermediaries, in particular tied agents, and corporate financiers, were most frequently mentioned. The main areas of conflict identified related to disclosure of commission (including "soft" commission), self-dealing, agency-crosses, Chinese walls and front-running. Outside the financial services field, insurance brokers, estate agents,[2] authorised conveyancing practitioners, licensed conveyancers, valuers and actuaries were said to face difficulties. Accountants referred to a particular problem arising out of the disclosure obligation imposed on them by FSA s. 109.[3]

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[1] See para. 1.11, above.

[2] But see para. 1.9, above.

[3] Although there is no conflict with the general law because the statute modifies the common law duty of confidentiality.

Q. 4.4 Where an individual or an organisation belongs to a number of self-regulating organisations, how, if at all, does this affect the relationship between the regulatory rules and the general law?

Although many respondents pointed out that there are discrepancies between the different sets of rules and that compliance with different sets of rules is time consuming and expensive, the vast majority do not consider that membership of a number of self-regulating organisations affects the relationship between the regulatory rules and the general law.

Q. 4.5 In relation to advisers, dealers, intermediaries of all sorts, and investment managers, are difficulties caused by the regulatory rules concerning the passing on or withholding of information acquired from or in connection with another client or former client? Consider, for instance, information acquired:

(a) by an estate agent who is acting for more than one of the vendors in a chain of property sales, from one of them,

(b) by an adviser from the corporate finance arm of his organisation, or

(c) by an insurance broker, from the underwriters.

We received no useful comments on paragraph (a). In relation to paragraph (b), a large majority of respondents indicated that the regulatory rules do not cause difficulties, primarily in reliance upon Chinese walls. Opinion on paragraph (c) was fairly evenly divided, the most cogent being that the regulatory rules do not cause difficulties and that such problems as there are arise from conflicts between practice in Lloyd's and the general law, rather than between the general law and Lloyd's rules. Approximately half of the respondents did not refer to the examples in the question but indicated that the relevant rules do not cause difficulties, primarily because they use Chinese walls.

It is difficult to assess the quality of many of the responses to this question, as not all of those who answered it gave reasons for their opinion. Of those that did, the main ground posited either way was the effectiveness (or lack of it), of Chinese walls. Thus, whether or not the regulatory rules concerning the passing on or withholding of information cause difficulties would seem to depend on whether or not Chinese walls are effective.

Q. 4.6 In relation to dealer/brokers, do the regulatory rules concerning all or any of the following cause difficulties in relation to the duties owed to the client by the dealer/broker as an agent or intermediary:

(a) the timing and order in which orders are executed,

(b) the aggregation of orders resulting perhaps in delay in execution,

(c) the allocation of transactions to clients,

(d) averaging,

(e) The exclusion of the best execution rule where the client is a professional.

In relation to each of paragraphs (a) to (e) a large majority of respondents said that the relevant regulatory rules do not cause difficulties in relation to the duties owed to the customer. It is difficult to assess the calibre of the responses as many did not go into details. Of those that did, in relation to (a) timing and order, (b) aggregation, (c) allocation and (d) averaging, most attributed the lack of problems to the fact that disclosure is made to the customer. In relation to (b), (c) and (d) one of the respondents who considers that there is a problem qualified its view by stating that there is only a problem in the absence of specific provision in the customer agreement. In relation to (e), the exclusion of best execution, most respondents referred to the difficulty of defining best execution. Some suggested that excluding the obligation to obtain best execution does not exclude the general duty to obtain the "best price". However, several attributed the lack of difficulty to advance disclosure in customer agreements. Whether or not there are difficulties, particularly in relation to paragraphs (a) to (d), thus seems to turn on whether or not advance disclosures in customer agreements are capable of modifying the relevant fiduciary duties.

Q. 4.7 In relation to investment managers and advisers, do the regulatory rules concerning all or any of the following cause difficulties in relation to their fiduciary duties:

(a) the allocation of investment opportunities (i) between clients and, (ii) between themselves and clients, as where, for instance an investment manager with clients who have invested in a general fund sets up a fund specialising in a particular sector (which is one of the sectors covered by the general fund), and then has to decide whether investment opportunities are to be offered or allocated to the general fund or to the specialist fund; and

(b) the polarisation requirements which, for example, oblige an adviser who is a tied agent of a firm with its own unit trusts to restrict advice to that product. Thus, even where he believes another product would be more appropriate, although he may suggest that an independent adviser be consulted, he can only advise the client about his own firm's product. Do you consider this a sufficient discharge of the tied agent's fiduciary duties?

In relation to paragraph (a) a majority of those who commented do not consider that the relevant regulatory rules cause difficulties in relation to fiduciary duties. Most did not give reasons for their opinion, and those that did differed in their views. The most convincing reason put forward was that the rules do not address the problem and that the difficulties encountered arise under the general law. The examples given by those who consider that there are problems do not arise from conflicts between the rules and fiduciary duties.

In relation to paragraph (b) opinion was fairly evenly split as to whether or not the regulatory rules cause difficulties in relation to fiduciary duties. However, approximately half of those who thought that they do were not sure whether tied agents owe fiduciary duties to their customers. If tied agents do not owe fiduciary duties any problems which may arise cannot be attributed to a mismatch between those duties and duties imposed by regulatory rules. The majority of those who thought that there were no difficulties attributed this to the fact that the tied agent's status is disclosed to the customer. Again, there was some uncertainty as to whether tied agents owe fiduciary duties to their customers, or only to the entity to which they are tied.

Q. 4.8 If the answer to all or any of the questions in paragraphs 4.5, 4.6 and 4.7 is "no", is this because the matter is dealt with in your customer agreement? If so, please explain.

A majority of respondents try to avoid some of the relevant difficulties by incorporating appropriate provisions in their customer agreements. Some back these up with other methods of managing conflicts, for example, disclosure other than in the customer agreement, Chinese walls and independence policies. Most did not comment on the individual paragraphs in the question, but those that did differ in what they try to cover. Half of those who do not rely on the terms of their customer agreements to deal with the relevant matters are insurance companies, or their representative bodies, most of which never use customer agreements. Thus, it seems that, throughout the financial services industry, (with the exception of insurance), much reliance is placed on the exclusions and disclosures in customer agreements.

Q. 4.9 Are there any problems with the rules governing client money? For example, (a) the operation of the requirement that such money be placed in a segregated account with an "approved bank", where the professional is associated with or controls the approved bank, and (b) the position of interest earned on margin money?

Few problems within the scope of our project arose from the rules governing client money. A majority of respondents, whether generally, or in relation to the examples in the question, do not consider that the rules governing client money caused problems. Many of those who gave reasons said that this is because disclosure is made in the customer agreement, whilst one referred to FSA section 55. Those problems which were identified relate primarily to the over-complexity of the rules rather than to any mismatch with fiduciary duties. The only suggestion of a potential mismatch is with the regulatory rule which allows a firm, in certain circumstances, to contract out of the payment of interest.

Q. 4.10 As regards authorised unit trusts, do the regulatory arrangements whereby (a) a manager can profit from its dealings or charge for its services or, (b) a trustee can (or where appropriate, must) delegate its powers and/or discretions, operate consistently with the whole range of the fiduciary duties owed to the client?

The vast majority of respondents, either in relation to the question generally, or to one or both of parts (a) and (b) think that as regards unit trusts the regulatory arrangements operate consistently with the whole range of fiduciary duties owed to the customer. The most common explanation given by those who addressed (a) and (b) separately was that disclosure that the relevant activity might take place is made to the customer, usually in the scheme particulars. The most common reason put forward by those who answered the question as a whole is based on FSA section 81.[4]

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[4] See further, para. 5.3.4, above.

Q. 4.11 In relation to trustees, does the scope of the exemption from regulation in Schedule 1 to the Financial Services Act cause problems? In particular does the fact that the exemption does not apply (a) to those who solicit or sell to or buy from the public or hold themselves out as so doing, perhaps by dealing through a broker, or an associated broking department, (paras. 17(1)(a), 22(1)(c)), (b) to those remunerated for advisory services in addition to remuneration for discharging their duty as trustee (para. 22(4)) lead to difficulties either in general or in the case of particular types of trustees, such as corporate trustees (including banks)?

A majority of respondents said, either generally, or in relation to part (b), that the scope of the exemption in Schedule 1 to the FSA causes problems. However these primarily relate to the restricted scope of the exemption in Schedule 1 and are not within the scope of this paper. We did not receive any cogent opinions on part (a).

Q. 4.12 In relation to trustees, if the exemption in Schedule 1 does not apply to you, to what extent have you found that the rules of your regulatory body conflict with your duties as a trustee?

A majority of respondents indicated that, in relation to trustees, there are no conflicts between the regulatory rules and trustees' duties. Some indicated that this was because IMRO has disapplied to trustees the rules which cause problems. The examples given by those who indicated that such conflicts exist do not, in fact, constitute such conflicts. The problems experienced in relation to trustees thus seem to arise from the inapplicability of the rules to the trust situation, rather than conflicts within the scope of this paper.

Q. 5.1 What form of disclosure and consent provision is used by your firm or, if you are the client, by your adviser, dealer/broker, intermediary or investment manager? Does it state that the firm has or may have a material interest, or that it is relying on Chinese Walls? If so, does it explain, (a) the nature of the interest (eg self-dealing), and (b) the fact that consent will limit the fiduciary duties owed? What is the quality and nature of the client's consent, i.e. how informed is it?

A majority of respondents, (all of whom are involved in the provision of financial services, or spoke as their advisers, representatives, or regulators), disclose that the firm has, or might have a material interest. A majority of these explain to some extent the nature and type of interest. The matters disclosed and detail of the disclosure varies, but the possibility of self-dealing, agency cross, dealing in the units of a unit trust scheme managed by the firm or of which the firm is trustee, being the financial adviser or lending banker to the issuer of relevant securities, front running, effecting of transactions pursuant to soft commission arrangements, trading or having traded for the firm's own account in the relevant securities, having underwritten the relevant securities within the preceding 12 months, being remunerated by the counterparty to any transaction or receiving a commission payable other than by the customer, are commonly disclosed where relevant. Very few respondents disclose that they might be relying on Chinese walls, but several incorporate statements that they are not obliged to disclose to, or take into account when acting for, the customer any information known to an individual in the firm which has not come to the notice of the individual advising the customer.

Most respondents said that their customer agreements do not state that consent will limit the fiduciary duties owed. However, many include terms which, in effect, provide that no fiduciary duties will arise outside the agreement.

A majority of those who commented on the nature and quality of the customer's consent are unsure as to how informed it is, or indicated that it depends on the sophistication of the client. Most of those who believe that it is informed said this is because they deal only with professional investors. Thus, there seems to be great doubt as to whether the consent of a private investor can be informed.

Q. 5.2 Where the client has consented to a modification or waiver of the fiduciary duty of an adviser, broker/dealer, intermediary or manager, is this consent renewed periodically? If so, how often and in what circumstances?

A large majority of the respondents who operate in the financial services industry do not renew consents periodically, but rely on the generalised consents given in customer agreements. Only three respondents said that they renew consents periodically. One of these was an accountant and the other the Law Society.

Q. 5.3 Do disclosure and consent requirements differentiate on the grounds of the relative experience of different clients?

The disclosure provisions used by a majority of respondents do not differentiate on the grounds of the relative experience of different customers, although several obtain written consents from private customers, but not from professionals. Some of those who use different disclosure provisions drew attention to the requirements of SRO rules of more detailed disclosure in relation to private customers. We presume that those who make the same disclosures regardless of the status of the customer must upgrade the disclosures made to professional customers to those required for private customers in order to comply with the SRO rules.

Q. 5.4 Is disclosure of material interest, self-dealing and dual agency made where duties of best execution are owed?

Most respondents disclose material interest, self-dealing and dual agency where duties of best execution are owed. Few explained when this disclosure is made, but those that did indicated that it takes place when customer agreements are sent out.

Q. 5.5 In what circumstances, if any, is further disclosure made at any time after the beginning of the business relationship? If it is, how often and in what circumstances (i.e. is it made for particular transactions or in respect of particular types of interests)?

Most respondents make further disclosure in certain circumstances after the beginning of the business relationship. Such disclosure is made where required by SRO rules, and occasionally in relation to particular conflicts.

Q. 5.6 In relation to advisers and intermediaries, have any difficulties arisen for advisers, for intermediaries or for clients out of the relationship between the duties owed to the client and the duties of disclosure about commission earned which are required under the regulatory rules?

A high percentage of respondents indicated that, in relation to advisers and intermediaries, no difficulties arise out of the relationship between the duties owed to the client and the regulatory rules about disclosure of commission. The point was made that the rules do not prohibit the making of any further disclosure which may be necessary to comply with the relevant fiduciary duty.

Q. 5.7 In relation to authorised unit trusts, do the trust deeds governing the unit trust schemes operated by your firm contain (a) power for the manager to charge for its services and/or profit from its dealings, and/or (b) power for the trustee to delegate its powers and discretions, and in particular to delegate all investment decisions to the manager of the scheme?

Many respondents indicated that the trust deeds governing the schemes operated by their firms give the manager the power to charge for services and profit from dealings and power over investment decisions. The Financial Services (Regulated Schemes) Regulations 1991, provide that disclosure of the manager's preliminary and periodic charges should be made in the deed (Regulation 2.02 and Schedule 1), and that it is the manager's duty to make investment decisions (Regulation 7.02).

Q. 6.1 Do the agreements upon which you transact business exclude or limit your liability in respect of fiduciary duties? If there is no exclusion or limitation we would appreciate information on this.

Although respondents were divided in their opinions as to whether their customer agreements exclude or limit liability in respect of fiduciary duties, with a majority stating that they do not, it appears that many of those practising in the financial services industry use similar clauses, either limiting fiduciary duties to those arising out of the agreement, or making specific disclosures of material interests and potential conflicts. It seems that the respondents merely have different views as to the effect of such clauses. Some consider that they exclude or limit fiduciary duties, and others that they modify them and that modification is different from limitation.

Q. 6.2 Do the agreements upon which you transact business provide that the relationship between the duties owed by the parties is exclusively defined by the agreement?

A majority of respondents said that the agreements on which they transact business do not provide that the relationship between the duties owed by the parties is exclusively defined by the agreement. However, one of these indicated that its agreements provide that the terms of the agreement represent the entire terms upon which it undertakes to do business with the client, which seems to amount to the same thing. It is not clear whether any other respondents utilise such a clause, so the answers to this question may be unreliable.

Q. 6.3 Certain fiduciary duties might hamper advisers, broker/dealers or fund managers from acting in a dual capacity, for instance acting as both principal or agent, market-maker and broker, or dealing with other associates. Do the agreements upon which you transact business exclude such obligations?

A majority of respondents exclude those fiduciary duties which would otherwise hamper them from acting in dual capacity, a few by means of disclosure rather than a specific exclusion clause.

Q. 6.4 Do the agreements upon which you transact business provide that the professional (a) is to be regarded as a principal and not as an agent or, (b) although an agent may nevertheless deal with the client as a principal on its own account?

Few respondents answered the question clearly. Of those that did, an equal number use agreements which provide that they are to be regarded as principal and not as agent, as use agreements which do not. However, a majority of respondents said that their agreements allow them, although an agent, to deal as a principal on their own account. Most did not state in which capacity they use which provision, but one said that the former, (a), is commonly used by market-makers and Eurobond dealers, and the latter, (b), by investment managers and broker/dealers.

Q. 6.5 Where regulatory rules permit it, do the agreements upon which you transact business exclude the duty of best execution? What considerations prompt this? How common is it, in your opinion, for agreements to exclude this duty?

Just over half the respondents exclude the duty of best execution in certain circumstances, for example, when dealing with market professionals, or when the size of the deal is such that it is impossible to obtain a price. The prime reason for this is that compliance with the duty entails many practical difficulties. Very few of those that retain the duty gave reasons for this. Those that did thought it commercially appropriate and practically convenient to do so.

Approximately two thirds of respondents thought it relatively common for the duty to be excluded. Exclusion seems to be most common in dealings with market counterparties, or where the firm acts as principal and less common in investment management agreements.

Q. 7.1 Do you consider separate corporate structures will suffice to avoid potential breach of some aspect of fiduciary obligations arising from (a) self-dealing, (b) conflicts of interest, (c) conflicting duties, and (d) imputation of information? If so, which? If not, please explain why not.

A large majority of respondents do not think that separate corporate structures, on their own, will suffice to avoid breaches of fiduciary duty. It is necessary to reinforce legal separation with effective physical separation and control of information flows.

Q. 7.2 Does your organisation use separate corporate structures for this purpose? If so, to what extent?

Most of the large financial institutions use separate corporate structures, usually for a combination of reasons, one of which is the avoidance of breach of fiduciary obligation. However, several use them purely for other purposes, for example for business, tax and regulatory reasons. The corporate structures vary, with different companies placing different functions in separate companies. However, investment management is often organised in a separate company, and corporate finance is usually separated from market-making and broking activities.

Q. 7.3 To what extent is it practically and financially possible to have separate corporate entities for all functions (e.g., advisory, broking, trusteeship)? Please specify the functions which tend to be and those which tend not to be organised in a separate corporate structure.

A majority of respondents consider that it is not practically and financially possible to use separate structures to avoid breaches of fiduciary duty. It would lead to inefficient use of capital and increased regulatory and administrative costs. Many of those that did think it possible were considering only the position of large integrated finance houses, and still commented on the disadvantages of increased costs and capital adequacy problems. It thus seems that the use of separate corporate structures does not represent a viable solution.

Opinions varied as to which activities are usually organised in separate corporate structures. Fund management, trustee activities, banking, unit trust management, and market-making and dealing were most commonly stated to be so organised. Several respondents indicated that it is uncommon for corporate finance activities to be segregated in a separate company, but a small number said that they are so segregated.

Q. 7.4 Does your organisation have in place a Chinese Wall separating departments and individuals? If so, (a) to what extent is it supervised by senior management and, (b) apart from senior management, who can "cross" it and by what procedure?

A majority of the respondents operating in the financial services field have in place Chinese walls, supervised by senior management or a combination of senior management and the compliance department. The extent of the supervision of most of these walls was not made clear. Accountants and solicitors also use Chinese walls in limited circumstances. Their walls are closely supervised by senior partners.

Chinese walls are most commonly crossed by analysts and administrative and support staff. A few respondents indicated that salesmen and brokers might also cross walls. Very few respondents have in place walls which are never crossed other than by senior management.

Permission of the compliance department or senior management usually has to be obtained before a wall may be crossed. Thereafter procedures seemed to vary, with some firms keeping detailed records of all crossings and some taking steps to inform the insider of his obligations. Other respondents did not indicate whether any further "official" steps were taken.

Q. 7.5 Where a person has been brought over a Chinese Wall (for instance an analyst brought in to assist the corporate finance department on a particular matter), what is the procedure thereafter in relation to that person's relationship with his clients. Is he (a) suspended from advising or dealing entirely, (b) suspended in relation to categories of transaction affected by the information he has acquired, or (c) not subject to any constraint?

The procedures adopted in relation to a person who has been brought over a Chinese wall vary. It is very uncommon for the person to be suspended from advising or dealing entirely (this only happened in relation to solicitors), or never to be subject to any restraint. Many said that the person will be suspended in relation to categories of transaction affected by the information, but others highlighted the problem that this could entail in the case of a high profile analyst, of alerting the market to the fact that something is afoot. Some, therefore, oblige the analyst to adopt a neutral stance in relation to the relevant security. Others indicated that the procedure varies from case to case, depending on the circumstances.

Q. 7.6 Does your organisation use (a) stop lists or (b) grey lists prohibiting or restricting dealing in specified transactions? If so, please describe how it works. If not, please explain why, and describe any alternative that you use.

Most respondents, particularly those operating in the financial services field, use both stop or "restricted" lists and grey or "watched" or "monitored" lists. The former are usually used in relation to publically available information, and often to control staff dealing, whilst the latter are used in relation to non-public, confidential, price-sensitive information.

Q. 7.7 Do you consider a Chinese Wall which separates departments and, when necessary, individuals but which is supervised by the senior management will suffice in practical and legal terms to deal with potential breach of some aspect of fiduciary duties arising from (a) self-dealing, (b) conflicts of interest, (c) conflicting duties, and (d) imputation of information? If so, which?

Most respondents practising in the financial services industry thought that Chinese walls would "usually" suffice to deal with breaches of some aspects of fiduciary duties. They did not specify which aspects, nor in what circumstances they would not suffice, and some stated that they would suffice only as a matter of practice. Almost a third of those who thought they would not suffice, thought that when combined with other measures such as separate corporate structures, physical separation and the minimisation of common directorships they might do so.

Very few respondents considered the individual sub-paragraphs. Those that did all thought that Chinese walls would suffice to avoid breaches of some aspects of fiduciary duties arising out of conflicts of interest and conflicting duties. Most thought they would in relation to self-dealing. A small majority thought they would not in relation to imputation of information.

Views on Reform Although the Questionnaire did not ask whether it was desirable for the law in this area to be amended, and if so, how, over a third of respondents expressed opinions on this.

As almost two thirds of respondents did not express an opinion on this, what follows cannot be regarded as reflecting the balance of opinion. Among those who did express opinions as to whether, and if so how, the law in this area should be amended no particular view prevailed. The largest group favours leaving the law as it is at present, but for a variety of reasons. Consumer interests stated that the common law is a valuable deterrent against abuse and protection for the public. Several respondents, including the British Merchant Banking and Securities Houses Association, consider that further change after all the changes in recent years would unsettle the market. They expressed confidence in the adequacy of existing techniques for resolving conflicts (contractual, disclosure and Chinese walls) and commercial pressures. A second body of opinion considers that the present uncertainty is unacceptable and that compliance with regulatory rules should provide protection against claims for breach of fiduciary duty. The final body believes that the law should be clarified in some way, but has different ideas as to how. For example, it was suggested that imputed knowledge should be abolished and replaced with a rebuttable presumption of knowledge, that a general provision along the lines of section 61 of the Trustee Act 1925 and section 727 of the Companies Act 1985, empowering a court to grant relief where a fiduciary has acted honestly and ought fairly to be excused, be enacted, and that the circumstances and manner in which consent to a conflict might be obtained and the effect and status of arrangements designed to establish Chinese walls be clarified.

APPENDIX 2

COMPANIES BILL 1973, CLAUSES 14 AND 52

Clause 14

(1) Neither section 12 nor section 13 above shall preclude a person from entering into any transaction if his purpose is not, or is not primarily, the making of a profit or the avoiding of a loss (whether for himself or another) by the use of any such information as is mentioned in those sections.

(2) Neither section 12 nor section 13 above shall preclude a person from entering into any transaction if-

(a) his sole purpose is the acquisition of qualification shares required by him as director or intending director of any company;

(b) he enters into the transaction in pursuance of a scheme approved under Schedule 12 to the Finance Act 1972 (share option and share incentive schemes);

(c) he enters into the transaction as agent for another person and has neither selected nor advised on the selection of the securities to which the transaction relates;

(d) he enters into the transaction in the bona fide performance of an underwriting agreement with respect to the securities to which the transaction relates;

(e) he enters into the transaction in the bona fide exercise of his functions as trustee of a pension fund established wholly or primarily for the benefit of employees of the company to whose securities the transaction relates or of a related company; or

(f) he enters into the transaction in the bona fide exercise of his functions as personal representative, liquidator, receiver or trustee in bankruptcy.

(3) A company shall not be precluded by subsection (5) or (6) of section 12 above from entering into any transaction by reason only of, or of having obtained, any information in the possession of a director or employee of that company if-

(a) the decision to enter into the transaction was taken on its behalf by a person other than the director or employee; and

(b) arrangements were then in existence for securing that the information was not communicated to that person and that no advice with respect to the transaction was given to him by a person in possession of the information; and

(c) the information was not in fact so communicated and advice was not in fact so given.

(4) A person shall not be precluded by subsection (3) of section 12 above from procuring a company to deal in any securities by reason only of his being in possession of information to the effect that the company intends to deal in those securities; and a company shall not be precluded by subsection (5) or (6) of that section from dealing in any securities by reason only of, or of having obtained, any such information in the possession of any of its directors or employees.

(5) For the purpose of determining under section 12(5)(a) above whether a person from whom information is obtained would himself be precluded from dealing in any securities the foregoing provisions of this section shall be left out of account.

Clause 52

(1) A director of a company shall observe the utmost good faith towards the company in any transaction with it or on its behalf and shall act honestly in the exercise of the powers and the discharge of the duties of his office.

(2) A director of a company shall not make use of any money or other property of the company, or of any information acquired by him by virtue of his position as a director or other officer of the company, to gain directly or indirectly an improper advantage for himself at the expense of the company.

(3) A director of a company who, by any breach of subsection (1) or (2) above, makes a profit or inflicts any damage on the company shall be liable to account to the company for the profit or to compensate it for the damage.

(4) This section is without prejudice to any other provision of the Companies Acts and to any rule of law with respect to the duties or liabilities of directors.

APPENDIX 3

EXTRACTS FROM THE CORE CONDUCT OF BUSINESS RULES AND THE FINANCIAL SERVICES GLOSSARY 1991 (SECOND EDITION)

Extracts From The Core Conduct of Business Rules

Independence

1 Inducements

A firm must take reasonable steps to ensure that neither it nor any of its agents:

a. offers or gives, or

b. solicits or accepts,

either in the course of regulated business or otherwise any inducement which is likely significantly to conflict with any duties of the recipient (or the recipient's employer) owed to customers in connection with regulated business.

2 Material interest

Where a firm has a material interest in a transaction to be entered into with or for a customer or a relationship which gives rise to a conflict of interest in relation to such a transaction, the firm must not knowingly either advise, or deal in the exercise of discretion, in relation to that transaction unless it takes reasonable steps to ensure fair treatment for the customer.

3 Soft commission

A firm which deals for a customer on an advisory basis or in the exercise of discretion may not so deal through a broker pursuant to a soft commission agreement unless:

a. the only benefits to be provided under the agreement are goods or services which can reasonably be expected to assist in the provision of investment services to the firm's customers and which are in fact so used;

b. the broker has agreed to provide best execution to the customer;

c. the firm is satisfied on reasonable grounds that the terms of business and methods by which the relevant broking services will be supplied do not involve any potential for comparative price disadvantage to the customer;

d. in transactions in which the broker acts as principal, he is not remunerated by spread alone; and

e. adequate prior and periodic disclosure is made.

4 **Polarisation**

1. A firm which advises a private customer on packaged products must either:

a. be a product company or its marketing group associate; or

b. do so as an independent intermediary.

2. A firm which is a product company or its marketing group associate must not advise private customers to buy packaged products which are not those of the marketing group.

3. A firm which acts as an independent intermediary in advising a private customer on packaged products must act as an independent intermediary whenever it advises private customers on packaged products in the course of regulated business.

4. But where a firm acts as an investment manager for a customer, the core rule on polarisation does not prevent the firm from advising the customer on any packaged product.

Advertising and Marketing

13 **Appointed representatives**

1. A firm must satisfy itself on reasonable grounds and on a continuing basis that any appointed representative it appoints is fit and proper to act for it in that capacity.

2. A firm must also satisfy itself on reasonable grounds and on a continuing basis that it has adequate resources to monitor and enforce compliance by its appointed representatives with high standards of business conduct.

3. A firm must ensure that any of its appointed representatives carries on regulated business for which the firm has accepted responsibility only:

   a. in circumstances where the representative does not carry on (or purport to carry on) in the United Kingdom any investment business for which the representative is not an authorised or exempted person; and

   b. in a way which ensures that the business for which the firm has accepted responsibility is, and is held out as being, clearly distinct from any financial business which the representative carries on which is not investment business, unless that other financial business is covered by authorisation under an enactment as a bank or building society;

   but a firm does not break this requirement if it can show it has taken reasonable steps to comply with it.

4. Subject to any exceptions contained in the rules of an SRO of which it is a member, a firm must ensure that its employment of any of its appointed representatives can be terminated only with the authority of its regulator.

Customer Relations

14 Customer agreements

1. Where a firm provides investment services to a private customer (other than an indirect customer) on written contractual terms, the agreement must set out in adequate detail the basis on which those services are provided.

2. Where a firm provides to a private customer (other than an indirect customer) investment services involving:

   a. contingent liability transactions; or

   b. the discretionary management of the customer's assets;

   it must do so under a two-way customer agreement unless the customer is ordinarily resident outside the United Kingdom and the firm believes on reasonable grounds that he does not wish a two-way agreement to be used.

15 Customers' rights

1. A firm must not, in any written communication or agreement, seek to exclude or restrict any duty or liability to a customer which it has under the Act, or under the regulatory system.

2. Similarly, unless it is reasonable to do so in the circumstances, a firm must not, in any written communication or agreement, seek to exclude or restrict:

   a. any other duty to act with skill, care and diligence which is owed to a private customer in connection with the provision to him of investment services in the course of regulated business; or

   b. any liability owed to a private customer in connection with regulated business for failure to exercise the degree of skill, care and diligence which may reasonably be expected of it in the provision of investment services in the course of that business.

3. A firm must not seek unreasonably to rely on any provision seeking to exclude or restrict any such duty or liability.

16 Suitability

1. A firm must take reasonable steps to ensure that it does not in the course of regulated business or associated business:

   a. make any personal recommendation to a private customer of an investment or investment agreement; or

   b. effect or arrange a discretionary transaction with or for a private customer or, subject to any exceptions contained in the rules of an SRO of which the firm is a member, any other customer;

   unless the recommendation or transaction is suitable for him having regard to the facts disclosed by that customer and other relevant facts about the customer of which the firm is, or reasonably should be, aware.

2. But where, with the agreement of the customer, a firm has pooled his funds with those of others with a view to taking common management decisions, the firm must instead take reasonable steps to ensure that the transaction is suitable for the fund, having regard to the stated investment objectives of the fund.

17 Standards of advice on packaged products

1. A firm which advises private customers to buy packaged products must take reasonable steps to inform itself and relevant agents:

    a. where the firm is a product company or its marketing group associate, about packaged products available from the marketing group; or

    b. where the firm is an independent intermediary, about packaged products which are generally available on the market and on which it can advise.

2. Where a firm is a product company or its marketing group associate, it must not advise a private customer to buy a packaged product, or buy a packaged product for him in the exercise of discretion, if it is aware of a packaged product of the marketing group which would better meet his needs.

3. Where a firm is acting as an independent intermediary, it must not advise a private customer to buy a packaged product, or buy a packaged product for him in the exercise of discretion, if it is aware of a generally available packaged product which would better meet his needs.

4. Where a firm is a product company or its marketing group associate and is acting as an investment manager, it must not advise a private customer to buy a packaged product of a product company outside the marketing group, or buy such a product for him in the exercise of discretion, if it is, or reasonably should be, aware of a generally available packaged product which would better meet his needs.

5. Where a firm is acting for a private customer as an independent intermediary but not as an investment manager, it must not advise him to buy a packaged product from its extended group if it is aware of a generally available packaged product which is not a product of the extended group and which would meet his needs as well as the extended group product.

6. In assessing the merits of a packaged product to be held as the plan investment of a personal equity plan, a firm must take into account the characteristics (including charging arrangements) of the plan, as well as those of the product.

18 Charges and other remuneration

1. The amount of a firm's charges to a private customer for the provision of investment services to him must not be unreasonable in the circumstances.

2. Subject to any exceptions contained in the rules of an SRO of which it is a member, before a firm provides investment services to a private customer (other than an indirect customer), it must disclose to him the basis or amount of its charges for the provision of those services and the nature or amount of any other remuneration receivable by it (or, to its knowledge, by its associate) and attributable to them.

19 Confirmations and periodic information

1. Subject to any exceptions contained in the rules of an SRO of which it is a member, a firm which effects a sale or purchase of an investment (other than a life policy) with or for a customer must ensure that he is sent with due despatch a note containing the essential details of the transaction.

2. Subject to any exceptions contained in the rules of an SRO of which it is a member, a firm which acts as an investment manager for a customer must ensure that he is sent at suitable intervals a report stating the value of the portfolio or account at the beginning and end of the period, its composition at the end, and, in the case of a discretionary portfolio or account, changes in its composition between those dates.

Dealing for customers

20 Customer order priority

A firm should deal with customer and own account orders fairly and in due turn.

21 Timely execution

1. Once a firm has agreed or decided in its discretion to effect or arrange a current customer order, it must effect or arrange the execution of the order as soon as reasonably practicable in the circumstances.

2. But the core rule on timely execution does not preclude a firm from postponing execution of an order where it believes on reasonably grounds that this is in the best interests of the customer.

22 Best execution

1. Where a firm deals with or for a private customer, it must provide best execution.

2. A firm must also provide best execution where it fulfils an order from a non-private customer.

3. A firm may rely on another person who executes the transaction to provide best execution, but only if it believes on reasonable grounds that he will do so.

4. For the purposes of the core rule on best execution, a firm provides best execution if:

   a. it takes reasonable care to ascertain the price which is the best available for the customer in the relevant market at the time for transactions of the kind and size concerned; and

   b. unless the circumstances require it to do otherwise in the interests of the customer, it deals at a price which is no less advantageous to him;

   and in applying the core rule on best execution, a firm should leave out of account any charges disclosed to the customer which it or its agent would make.

5. The core rule on best execution does not require a firm to provide best execution on a purchase of a life policy or on a purchase from the operator of a regulated collective investment scheme of units in the scheme.

23 Timely allocation

A firm must ensure that a transaction it executes is promptly allocated.

24 Fair allocation

Where a firm has aggregated an order for a customer transaction with an order for an own account transaction, or with another order for a customer transaction, then in the subsequent allocation:

a. it must not give unfair preference to itself or to any of those for whom it dealt; and

b. if all cannot be satisfied, it must give priority to satisfying orders for customer transactions unless it believes on reasonable grounds that, without its own participation, it would not have been able to effect those orders either on such favourable terms or at all.

25 Dealing ahead of publications

Subject to any exceptions contained in the rules of an SRO of which it is a member, where a firm or its associate intends to publish to customers a recommendation or a piece of research or analysis, it must not knowingly effect an own account transaction in the investment concerned or any related investment until the customers for whom the publication was principally intended have had (or are likely to have had) a reasonable opportunity to react to it.

26 Churning and switching

1. A firm must not:

   a. make a personal recommendation to a private customer to deal; or

   b. deal or arrange a deal in the exercise of discretion for any customer;

   if the dealing would reasonably be regarded as too frequent in the circumstances.

2. A firm must not:

   a. make a personal recommendation to a private customer to switch within a packaged product or between packaged products; or

   b. effect such a switch in the exercise of discretion for a private customer;

   unless it believes on reasonable grounds that the switch is justified from the customer's viewpoint.

27 Certain derivatives transactions to be on exchange

A firm must not effect, arrange or recommend a contingent liability transaction with, for or to a private customer unless:

a. the transaction is made on a recognised or designated investment exchange; or

b. the firm believes on reasonable grounds that the purpose of the transaction is to hedge against currency risk involved in a position which the customer holds.

Market integrity

28 Insider dealing

1. A firm must not effect (either in the United Kingdom or elsewhere) an own account transaction when it knows of circumstances which mean that it, its associate, or an employee of either, is prohibited from effecting that transaction by the statutory restrictions on insider dealing.

2. A firm must use its best endeavours to ensure that it does not knowingly effect (either in the course of regulated business or otherwise) a transaction for a customer it knows is so prohibited.

3. But the core rule on insider dealing does not apply where:

    a. the prohibition applies only because of knowledge of the firm's own intentions;

    b. the firm is a recognised market maker with obligations to deal in the investment; or

    c. the firm is a trustee or personal representative who acts on the advice of a third party appearing to be an appropriate adviser who is not so prohibited.

29 Stabilisation of securities

Where a firm takes action (either in the course of regulated business or otherwise) for the purpose of stabilising the price of securities, it must comply with any applicable provisions of the statutory stabilisation rules.

30 Off-exchange market makers

Where a firm sells to a private customer any securities which are not quoted on a recognised or designated investment exchange, whilst giving the customer the impression that the firm is a market maker in the investment concerned, it must:

a. give notice to the customer that it is required to ensure that a reasonable price for repurchase of the investment is available to him for a specified period which must not be less than three months after the date the notice is given; and

b. ensure that such a price is available to him for that specified period.

31 Reportable transactions

Unless otherwise provided by the rules of an SRO of which it is a member, a firm must make available to its regulator details about transactions (including own account transactions) in securities which it effects other than on a recognised investment exchange.

Administration

34 Compliance

1. A firm must take reasonable steps, including the establishment and maintenance of procedures, to ensure that its officers and employees and officers and employees of its appointed representatives act in conformity with:

   a. their own and their employer's relevant responsibilities under the regulatory system;

   b. where relevant, the requirements of the statutory restrictions on insider dealing; and

   c. appropriate arrangements on propriety in personal dealings.

2. A firm must take reasonable steps, including the establishment and maintenance of procedures, to ensure that sufficient information is recorded and retained about its regulated business and compliance with the regulatory system.

3. Records required to be maintained by the regulatory system may be inspected by a person appointed for the purpose by the firm's regulator.

36 Chinese walls

1. Where a firm maintains an established arrangement which requires information obtained by the firm in the course of carrying on one part of its business of any kind to be withheld in certain circumstances from persons with whom it deals in the course of carrying on another part of its business of any kind, then in those circumstances:

   a. that information may be so withheld; and

   b. for that purpose, persons employed in the first part may withhold information from those employed in the second;

but only to the extent that the business of one of those parts involves investment business or associated business.

2. Information may also be withheld where this is required by an established arrangement between different parts of the business (of any kind) of a group, but this provision does not affect any requirement to transmit information which may arise apart from the Core Conduct of Business Rules.

3. Where the Core Conduct of Business Rules apply only if a firm acts with knowledge, the firm is not for the purposes of the Core Conduct of Business Rules to be taken to act with knowledge if none of the relevant individuals involved on behalf of the firm acts with knowledge.

4. In addition, in order to avoid the attribution of information held within a firm to that firm for the purposes of section 47 of the Act, the effect of section 48(6) of the Act is that nothing done in conformity with paragraph (1) of the core rule on Chinese walls is to be regarded as a contravention of section 47 of the Act.

General

38 Reliance on others

1. A person is to be taken to act in conformity with the Core Conduct of Business Rules to the extent that:

    a. the relevant regulator has issued formal guidance on compliance with them; and

    b. in reliance on standards set in that guidance, the person concerned believes on reasonable grounds that he is acting in conformity with the rules.

2. A person is to be taken to act in conformity with any of the Core Conduct of Business Rules as to information, to the extent that he can show that he reasonably relied on information provided to him in writing by a third party whom he believed on reasonable grounds to be independent and competent to provide the information.

3. Any communication required under the Core Conduct of Business Rules to be sent to a customer may be sent to the order of the customer, so long as the recipient is independent of the firm; and there is no need for a firm to send a communication itself where it believes on reasonable grounds that this has been or will be supplied direct by another person.

39 Classes of customer

1. The Core Rules on Conduct of Business apply subject to any exceptions contained in the rules of an SRO of which the firm is a member which enable it to treat a customer who would otherwise be a private customer as a non-private customer for the purposes of the Core Conduct of Business Rules if:

   a. it can show that it believes on reasonable grounds that the customer has sufficient experience and understanding to waive the protections provided for private customers;

   b. it has given a clear written warning to the customer of the protections under the regulatory system which he will lose; and

   c. the customer has given his written consent after a proper opportunity to consider that warning.

2. But SRO rules need not require written consent where the customer is ordinarily resident outside the United Kingdom and is reasonably believed not to wish to consent in writing.

40 Application of the Core Conduct of Business Rules

Business

1. a. The general application of the Core Conduct of Business Rules is that, as far as they relate to business, they relate to business which is regulated business, and accordingly, where a rule relating to business applies only in particular circumstances, the rule applies only if those circumstances apply in the course of regulated business.

   b. To the extent indicated, the Core Conduct of Business Rules also apply to the carrying on (whether in the UK or elsewhere) of other business if that other business is investment business, associated business or business which is held out as being for the purposes of investment.

   c. The Core Conduct of Business Rules do not apply to authorised persons to the extent that they are acting as authorised persons certified by recognised professional bodies (since these persons are subject to regulation by those bodies) or to the extent that they are acting as exempted persons.

   d. The Core Conduct of Business Rules are limited in their application to regulated insurance companies (by paragraph 4 of Schedule 10 to the Act), to regulated friendly societies (by paragraph 14 of Schedule 11 to the Act) and to certain UCITS operators and trustees (by section 86(7) of the Act).

e. The Core Conduct of Business Rules apply to an oil market participant subject to exceptions contained in the rules of an SRO of which the firm is a member.

f. Where the firm is:

(i) a journalist, broadcaster, author or publisher;

(ii) whose only investment business is the provision of investment advice;

the Core Conduct of Business Rules apply subject to exceptions contained in the rules of an SRO of which the firm is a member.

Time

3. The application of the Core Conduct of Business Rules as to time is that they apply to a firm from the date specified for firms of the relevant class in a separate commencement instrument made by the Board (subject to any transitional provisions contained in that instrument).

Interpretation

4. a. The Financial Services Glossary 1991 (Second Edition) applies, unless the context otherwise requires, for the interpretation of the Core Conduct of Business Rules.

b. Any other expressions defined for the purposes of the Act, or in the Interpretation Act 1978, have the same meanings in the Core Conduct of Business Rules.

c. These rules may be cited as the Core Conduct of Business Rules. They are made under section 48 of and, for friendly societies, paragraph 14 of Schedule 11 to, the Act. They are designated so as to apply directly to members of recognised self-regulating organisations under section 63A of and, for friendly societies, paragraph 22B of Schedule 11 to, the Act.

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The Financial Services Glossary 1991 (Second Edition)

Introduction

1. This Glossary is designed to establish standard meanings for expressions used in rules or regulations made by the Board under the Financial Services Act 1986.

2. Where these standard meanings are to apply, this will be stated in the rules or regulations concerned.

3. This text shows the meanings established as at 20 June 1991.

Glossary

1. The following expressions have the following meanings unless the context otherwise requires:

the **Act** means the Financial Services Act 1986;

agent, in relation to a person, means any person (including an employee) who acts on that person's behalf;

ancillary, in relation to an investment, means any right to or interest in that investment which falls within paragraph 11 of Schedule 1 to the Act;

approve, in relation to an investment advertisement, means approve for the purposes of section 57 of the Act;

associate in relation to a person, means:

a. an undertaking in the same group as that person;

b. an appointed representative of the first person or of any undertaking in the same group; and

c. any other person whose business or domestic relationship with the first person or its associate might reasonably be expected to give rise to a community of interest between them which may involve a conflict of interest in dealings with third parties;

associated business means business which is carried on in connection with investment business;

broker includes broker-dealer;

buy has the meaning given by paragraph 28 of Schedule 1 to the Act;

the Board means the Securities and Investments Board;

callable investment services means investment services where the only investments involved are:

a. generally marketable non-geared packaged products; and

b. readily realisable securities other than warrants;

cancellable customer agreement means a written customer agreement (which may be a one way customer agreement):

a. under which investment services may be provided only after the expiry of a period of seven days from the date on which the customer can reasonably be expected to have received a copy of it; and

b. which the customer can cancel without cost during that period;

certificates representing securities means investments falling within paragraph 5 of Schedule 1 to the Act;

charges means any charges made to a customer in connection with investment services, including any mark-up or mark-down from the price at which best execution would be achieved;

close relative in relation to a person, means the person's spouse, his children and step-children, his parents and step-parents, his brothers and sisters and his step-brothers and step-sisters;

contingent liability transaction means a derivatives transaction under the terms of which the customer will or may be liable to make further payments (other than charges, and whether or not secured by margin) when the transaction falls to be completed or upon the earlier closing out of his position;

contract for differences means an investment falling within paragraph 9 of Schedule 1 to the Act;

current customer order includes both a customer order for immediate execution and, once the condition is fulfilled, a customer order which is only to be executed on fulfilment of a condition;

customer does not include a market counterparty or a trust beneficiary but includes:

a. a potential customer;

b. an indirect customer; and

c. a customer of an appointed representative of a firm with or for whom the representative acts in the course of busienss for which the firm has accepted responsibility;

customer transaction does not include an own account transaction;

dealer means, for the purposes of the Common Unsolicited Calls Regulations, a person who by way of business enters into or is to enter into the investment agreement with the investor;

dealing restriction means the restriction in section 56(1) of the Act on entering into an investment agreement;

debenture means an investment falling within paragraph 2 of Schedule 1 to the Act;

derivatives means options, futures and contracts for differences;

designated investment exchange means any investment exchange which is designated by the Board as a designated investment exchange for the purposes of the Financial Services (Conduct of Business) Rules 1990 or the Core Conduct of Business Rules;

DIE advertisement means an advertisement:

a. issued by a designated investment exchange; or

b. required or permitted to be published by the rules of a designated investment exchange;

direct offer advertisement means a specific investment advertisement (including a pre-printed or off-the-screen advertisement) which:

a. contains:

(i) an offer by the firm or another offeror or to enter into an investment agreement with anyone who responds to the advertisement; or

(ii) an invitation to anyone to respond to the advertisement by making an offer to the firm or another offeree to enter into an investment agreement; and

b. specifies the manner or indicates a form in which any response is to be made (for example by providing a tear-off slip);

disclosable commission means commission which the regulatory system requires to be disclosed to a customer;

eligible nominee means:

a. an individual chosen by the customer who is not known by the firm to be an associate of the firm;

b. a corporate nominee with no other business; or

c. an institution authorised under the anking Act 1987;

exception, in relation to the rules of an SRO, means any provision made after 1 February 1991 which expressly disapplies or qualifies any particular Core Conduct of Business Rule in relation to a specific description of member firms, customers, transactions or circumstances;

exempt advertisement means an investment advertisement which can lawfully be issued in the United Kingdom by a person who is not an authorised person without approval of its contents by an authorised person;

exempted person means an exempted person acting in the course of business for which he is exempt;

existing customer relationship means a relationship under which the customer has been and remains an actual customer in relation to investment business;

extended group means the extended group consisting of the members of a group of undertakings and the marketing group associates of any of them;

financial business means business which is, or is held out as being, primarily for the purposes of investment;

firm means an authorised person under the Act;

formal guidance means guidance which is intended to have continuing effect and is issued:

a. generally or to a class of persons; and

b. in writing or other legible form;

fund of funds means a scheme dedicated to a number of collective investment schemes

future means an investment falling within paragraph 8 of Schedule 1 to the Act;

geared futures and options fund has the meaning given by the Financial Services (Regulated Schemes) Regulations 1991;

geared investment trust savings scheme means an investment trust savings scheme investing in an investment trust whose borrowing exceeds 50% of the market value of shares held by the trust at the mid-value share price;

geared packaged product means a packaged product which is a higher volatility product or a life policy with a link (including a potential link) to a higher volatility product;

geared securities fund means a regulated collective investment scheme where the policies which the operator adopts or proposes to adopt mean that, as a result of investment in warrants, movements in prices of units are likely to be amplified significantly;

generally marketable in relation to a packaged product, means that the packaged product is a unit in a regulated collective investment scheme, an investment trust saving scheme, or a life policy which can be marketed in the United Kingdom without contravention of section 130 of the Act;

government and public securities means investments falling within paragraph 3 of Schedule 1 to the Act;

group, except in relation to a marketing group, has the meaning given by paragraph 30 of Schedule 1 to the Act;

higher volatility product means:

a. a warrant fund, a geared futures and options fund, a geared securities fund, or a geared investment trust savings scheme; or

b. any intermediate fund which enables investment to be made in a fund (including another intermediate fund) which is a higher volatility product;

indirect customer means, where a customer is known to be acting as agent, an identified principal who would be a customer if he were dealt with direct;

inducement does not include:

a. disclosable commission; or

b. goods or services which can reasonably be expected to assist in the provision of investment services to customers and which are provided or to be provided under a soft commission agreement;

intermediate fund means an umbrella fund or a fund of funds;

investor means, for the purposes of the Common Unsolicited Calls Regulations, the person on whom the call is made and who enters into, or is procured or endeavoured to be procured to enter into, the investment agreement;

investment manager means a person who, acting only on behalf of a customer, either:

a. manages an account or portfolio in the exercise of discretion; or

b. has accepted responsibility on a continuing basis for advising on the composition of the account or portfolio;

investment services means activities undertaken in the course of carrying on investment business;

investment trust means a closed-ended company which is listed in the United Kingdom or another member state and:

a. is approved by the Inland Revenue under section 842 of the Income and Corporation Taxes Act 1988 (or, in the case of a newly formed company has declared its intention to conduct its affairs so as to obtain approval); or

b. is resident in another member state and would qualify for approval if resident and listed in the United Kingdom;

investment trust savings scheme means a dealing service dedicated to the securities of a particular investment trust or of investment trusts within a particular marketing group (and references to an investment trust savings scheme include references to securities to be acquired through that scheme);

issue includes cause to be issued;

life policy means an investment falling within paragraph 10 of Schedule 1 to the Act;

market counterparty means a person dealing with the firm:

a. as principal or as agent for an unidentified principal; and

b. in the course of investment business of the same description as that in the course of which the firm acts;

marketing group means a group of persons who:

a. are allied together (either formally or informally) for purposes of marketing packaged products of the group; and

b. each of whom, if it holds itself out in the United Kingdom as marketing any packaged products to private investors, does so only as an investment manager or in relation to those of the marketing group;

marketing group associate, in relation to a person in a marketing group, means any other person which is a member of that marketing group;

marketing restriction means the restriction in section 56(1) of the Act on procuring or endeavouring to procure a person to enter into an investment agreement;

market maker, in relation to an investment of any description, means a person who (otherwise than in his capacity as the operator of a regulated collective investment scheme) holds himself out as able and willing to enter into transactions of sale and purchase in investments of that description at prices determined by him generally and continuously rather than in respect of each particular transaction;

material interest, in relation to a transaction, does not include:

a. disclosable commission on the transaction; or

b. goods or services which can reasonably be expected to assist in the provision of investment services to customers and which are provided or to be provided under a soft commission agreement;

non-private customer means a person who is not a private customer or who has elected to be treated as a non-private customer in accordance with SRO rules made under the authority of the Core Rules;

non-private investor means a person who is not a private investor;

non-geared packaged product means a packaged product which is not a geared packaged product;

oil market participant has the same meaning as in the Financial Services (Conduct of Business) Rules 1990;

on exchange, in relation to a transaction, means that the transaction is effected:

a. on the exchange;

b. under the rules of the exchange; or

c. as a transaction which is both matched and identified as matched with an on exchange transaction;

option means an investment falling within paragraph 7 of Schedule 1 to the Act;

order, in relation to an order from a customer, means-

a. an order to a firm from the customer to effect a transaction as agent;

b. any other order to a firm from the customer to effect a transaction in circumstances giving rise to similar duties as those arising on an order to effect a transaction as agent;

c. a decision by a firm in the exercise of discretion for the customer;

ordinary business investor means-

a. a government, local authority or public authority within the meaning of Schedule 1 to the Act;

b. a company or partnership which satisfies any of the following size requirements:

(i) that it is a body corporate members which has more than 20 members (or is the subsidiary of a company which has more than 20 members) and it (or any of its holding companies or subsidiaries) has a called up share capital or net assets of £500,000 or more;

(ii) that it is a body corporate and it (or any of its holding companies or subsidiaries) has a called up share capital or net assets of £5 million or more; or

(iii) if it is not a body corporate, it has net assets of £5 million or more; or

c. a trustee of a trust which satisfies either of the following size requirements:

(i) that the aggregate value of the cash and investments which form part of the trust's assets (before deducting the amount of its liabilities) is £10 million or more; or

(ii) that aggregate value has been £10 million or more at any time during the previous two years;

overseas person means a person who carries on investment business but who does not do so from a permanent place of business maintained by him in the United Kingdom;

overseas person call means a call made by or on behalf of an overseas person and with a view to the provision of investment services:

a. to a person in the United Kingdom; and

b. by an overseas person who is not an authorised person in relation to those services;

own account transaction means a transaction

a. effected or arranged by the firm in the course of carrying on either investment business or associated business; and

b. on its own account or on the account of an associate acting on its own account;

packaged product means a life policy, a unit in a regulated collective investment scheme, or an investment trust savings scheme;

prescribed disclosure means a written statement which must make clear:

a. that all or most of the protections provided by the UK regulatory system do not apply; and

b. where the business is excluded form the Investors Compensation Scheme by its territorial, scope (or would be so excluded if the person carrying it on were a participant firm), a statement that compensation under that scheme will not be available;

and which may also indicate the protections or compensation available under another system of regulation;

Principles means the Statements of Principle made by the Board on 15 March 1990;

private customer means:

a. a customer who is an individual and who is not acting in the course of carrying on investment business; or

b. unless he is reasonably believed to be an ordinary business investor, a customer who is a small business investor;

private investor means an investor who is an individual and who is not acting in the course of carrying on investment business;

product company means:

a. in relation to a life policy, the life office by which that policy is issued;

b. in relation to units in a regulated collective investment scheme, the operator of that scheme;

c. in relation to an investment trust savings scheme, the operator of that scheme;

readily realisable securities means government and public securities denominated in the currency of the issuer and other securities which are:

a: admitted to official listing on an exchange in a member state; or

b. regularly traded on such an exchange or on a recognised investment exchange;

recognised market maker means a person (whether an individual, partnership or company) who:

a. holds himself out at all normal times in compliance with the rules of a recognised investment exchange as willing to buy and sell securities at prices specified by him; and

b. is recognised as doing so by that recognised investment exchange;

regulated business means investment business which is:

a. business carried on from a permanent place of business maintained by a firm (or its appointed representative) in the United Kingdom; and

b. other business carried on with or for customers in the United Kingdom, unless that business is:

(i) business carried on from an office of a firm outside the United Kingdom which would not be treated as carried on in the United Kingdom if that office were a separate person; or

(ii) business of an appointed representative of the firm which is not carried on in the United Kingdom;

regulated collective investment scheme means an authroised unit trust scheme or a recognised scheme;

regulated friendly society has the meaning given by paragraph 1 of Schedule II to the Act;

regulated insurance company means an insurance company:

a. to which Part II of the Insurance Companies Act 1982 applies; or

b. which is an authorised person by virtue of section 31 of the Act;

regulated life office means a regulated insurance company or a regulated friendly society;

regulator, in relation to a firm, means:

a. where the firm is a member of an SRO, that SRO;

b. where the firm is certified by a recognised professional body, that body; and

c. otherwise, the Board;

regulatory system means the arrangements for regulating a firm under the Act including the Principles, the Core Conduct of Business Rules and the rules of its regulator;

sale has the meaning given by paragraph 28 of Schedule 1 to the Act;

scheme particulars means a document containing information about a regulated collective investment scheme and subject to requirements as to the content of scheme particulars made either:

a. under the Act; or

b. in the case of a scheme recognised under section 86 of the Act, by the certifying member state;

securities means shares, debentures, government and public securities, warrants and certificates representing securities;

settlor includes intending settlor and, in Scotland, truster;

share means an investment falling within paragraph 1 of Schedule 1 to the Act;

small business investor means:

a. a company or partnership; or

b. a trustee acting for a trust;

which does not satisfy a size requirement enabling the company, partnership or trustee to be treated as an ordinary business investor;

soft commission agreement means any agreement whether oral or written, under which a firm which deals in securities on an advisory basis or in the exercise of dsicretion receives goods or services in return for an assurance that not less than a certain amount of such business will be put through or in the way of another person;

specific investment advertisement means an investment advertisement which identifies and promotes a particular investment or particular investment services;

SRO means a recognised self-regulating organisation;

statutory restrictions on insider dealing means the Company Securities (Insider Dealing) Act 1985;

statutory stabilisation rules means Part 10 of the Financial Services (Conduct of Business) Rules 1990;

takeover advertisement means an advertisement to which the Takeover Code applies (or would apply but for any exemption granted by the Panel on Takeovers and Mergers);

Takeover Code means the City Code on Takeovers and Mergers and the Rules Governing Substantial Acquisitions of Shares published by the Panel on Takeovers and Mergers;

trust beneficiary means a beneficiary under a trust (not being the settlor) who benefits from the performance by a firm as trustee of investment services relating to the management of the trust assets;

two-way customer agreement means an agreement in written form to which the customer has signified his assent in writing in circumstances where the firm is satisfied that the customer has had a proper opportunity to consider its terms; and

umbrella fund means a collective investment scheme which provides for such pooling as is mentioned in section 73(3)(a) of the Act in relation to separate constituent parts of the property and participants in which are entitled to exchange rights in one constituent part for rights in another;

warrant means an investment falling within paragraph 4 of Schedule 1 to the Act;

warrant fund has the meaning given by the Financial Services (Regulated Schemes) Regulations 1991.

2. Neither a soft commission agreement, nor an arrangement for the payment of disclosable commission, is to be taken for the purposes of the core rule on material interest as a relationship which gives rise to a conflict of interest in relation to transactions effected under the agreement or arrangement.

3. References to an investment include an ancillary on that investment.

4. Any expression which is related to an expression defined in this Glossary is to be construed accordingly.

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